

## **CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **Chapter 9 Controlled Foreign Corporations**

#### ***Contents:***

- 9.1 INTRODUCTION
- 9.2 SUBPART F INCOME
- 9.3 FOREIGN BASE COMPANY INCOME
- 9.4 TREATMENT OF PARTNERSHIP INCOME AND HYBRID BRANCHES  
UNDER SUBPART F RULES

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### Section 9.1 Controlled Foreign Corporations Introduction

#### ***Contents:***

- a. Introduction
- b. The History of Subpart F
- c. Definitions
  - 1. CFC in General
  - 2. United States Shareholder
  - 3. Domestic and Foreign Corporations
  - 4. Stock Ownership
  - 5. Deemed Control
- d. Application of Unity
- e. Summary

#### ***References:***

Revenue and Taxation Code §25110(a)(7)  
California Code of Regulations §25110(d)(2)(F)  
Internal Revenue Code §957

#### ***Training Objectives:***

This section of the Water's-Edge Manual introduces the concept of a controlled foreign corporation (CFC), defined by Internal Revenue Code (IRC) §957. A working knowledge of IRC §957 is required to effectively examine the California combined report of a domestic corporation with foreign subsidiaries. At the end of §9.1, you will have a basis understanding of the requirements a foreign corporation must meet to satisfy the definition of a CFC.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **a.     *Introduction***

For state returns prepared on a worldwide basis, treatment of a CFC is straightforward. A CFC is treated in the same manner as any other foreign corporation. The CFC's income and factors are added to the computation of apportionable income. Appropriate adjustments are made to translate the foreign income statement to California tax accounting standards, and appropriate adjustments are made for any intercompany transactions. A state adjustment may be required to remove any "deemed dividend" that might be included in the federal taxable income. This deemed dividend reflects the United States shareholder's portion of the CFC's "subpart F" income. The auditor does not have to be concerned with the federal rules regarding CFCs with subpart F income. The deemed dividend is simply removed from the California taxable income. Using the federal Form 5471 or financial statement information, the auditor reconciles the net income shown on the state return to ensure 100 percent of the CFC's income is included in the worldwide combined report.

With the advent of water's-edge legislation, unitary CFCs with subpart F income are partially included in the water's-edge combined return. The inclusion of a CFC's income and factors depends upon the ratio of the CFC's subpart F income to its earnings and profits for the taxable year. Accordingly, the ratio of inclusion can vary annually. This is in sharp contrast to the full inclusion of the CFC's income and factors in a worldwide combined report.

CFCs are significant to the auditor assigned to audit a water's-edge return because if a foreign corporation meets the definition of a CFC, it may be partially included in the water's-edge return. Thus, the auditor must know more about CFCs with subpart F income. Because there are significant differences between state and federal law in the treatment of CFCs with subpart F income, the auditor will need to look beyond the federal return for information.

Section 9.1, Water's-Edge Manual will introduce you to the federal rules that define a CFC. Section 9.2, Water's-Edge Manual describes the federal to state differences in regards to the treatment of CFCs with subpart F income and also describes the definition of subpart F income. Section 9.3, Water's-Edge Manual discusses foreign base company income, the most common type of subpart F income.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***b. The History Of Subpart F***

The major tax advantage of a foreign corporation is that foreign source income is generally not taxed by the United States. A United States corporation is taxed by the United States on all of its income whether it is earned inside or outside of the United States. Thus, the potential existed for United States corporations to defer or shift income to foreign countries with minimal or no United States tax by establishing a foreign subsidiary.

By the early 1960s, United States corporations had many foreign affiliates. In the DuPont case<sup>1</sup>, the taxpayer manufactured products in the United States, which it sold to a Swiss affiliate. The Swiss affiliate had little substance and merely functioned as a re-invoicing center for sales to related parties in high-tax jurisdictions in Europe. The Internal Revenue Service was able to demonstrate that the sole purpose of the Swiss affiliate was to reduce United States tax, and sustained IRC §482 adjustments to DuPont for undercharging the Swiss affiliate.

To combat these abuses, in 1961, President Kennedy proposed eliminating any tax deferral benefit for all United States corporations operating through foreign subsidiaries. This change was prompted by the DuPont case and also by the need to raise tax revenues. After much controversy, in 1962 Congress enacted the proposal, modified to tax only specific types of income and investments referred to as "subpart F" income, defined by IRC §951 through IRC §964.

The term "subpart F income" refers to the location of the provisions in the IRC, Subtitle A, Chapter 1, Subchapter N, Part III, "Subpart F". For federal purposes, the effect of subpart F is if a foreign corporation meets the definition of a CFC, then any of its income that meets the definition of subpart F income, is considered a deemed dividend to the United States shareholder(s), regardless of whether or not the income is actually distributed. California never conformed to these code sections until the enactment of Revenue and Taxation Code (RTC) §25110.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **c. Definitions**

#### **1. CFC In General**

IRC §957 defines a CFC as any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock is owned by United States shareholders on any day during the taxable year.<sup>2</sup> The United States shareholders do not have to be related to each other. The Treasury Regulations (TR) add as another condition that the more than 50 percent ownership must exist for an uninterrupted period of 30 days or more.<sup>3</sup>

IRC §957(b) states that certain CFCs need only have 25 percent of either their total stock vote or total stock value owned by United States shareholders. These CFCs are corporations which derive premium income from reinsurance or issuing insurance or annuity contracts in connection with property or activities of a country other than the CFC's country of incorporation. If this insurance income, described in IRC §953(a)(1), exceeds 75 percent of the gross insurance income, then this 25 percent ownership rule applies. The general rule (50 percent ownership) applies to all foreign corporations with income derived from any activity except insurance.

#### **2. United States Shareholder**

There must be at least one United States shareholder. A United States shareholder is a United States person(s) that owns 10 percent or more of the foreign corporation.<sup>4</sup> The ownership percentages of all the United States shareholders are then added together. If the sum exceeds 50 percent, then the foreign corporation is a CFC.

A United States person is defined as:

1. a citizen or resident of the United States;
2. a domestic corporation;
3. a domestic partnership; or
4. an estate or trust other than a foreign estate or trust.<sup>5</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

An exception exists for corporations generating premium income from insurance or reinsurance activity. The "10 percent or more" ownership rule does not apply. Thus for this type of corporation, a United States shareholder is a United States person that owns any stock in a foreign insurance company.<sup>6</sup> If the sum of any United States ownership in an insurance company exceeds 25 percent, then the insurance company is a CFC.

### ***3. Domestic And Foreign Corporations***

A domestic corporation is a corporation that is created or organized in the United States, including any state, the District of Columbia or any territory.<sup>7</sup> A foreign corporation is a corporation which is not domestic.

A United States possession includes Guam, the Mid-way Islands, the Panama Canal Zone, the Commonwealth of Puerto Rico, American Samoa, the Virgin Islands and Wake Island.<sup>8</sup> A CFC does not include a corporation that is organized or created in a United States possession if it satisfies the tests listed below:

1. 80 percent of the gross income of such corporation for the three-year period immediately preceding the close of the taxable year was derived from sources within a possession of the United States; and
2. 50 percent or more of the gross income for the above listed period was derived from the active conduct within a possession of the United States of one or more trades or businesses constituting:
  - a. manufacturing or processing of tangible personal property;
  - b. processing of agricultural or horticultural products or commodities;
  - c. catching or taking of fish or any manufacturing or processing of products or commodities obtained from such activities;
  - d. mining or extraction of natural resources or any manufacturing or processing of any products or commodities obtained from such activities; or
  - e. ownership or operation of hotels.<sup>9</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **4. Stock Ownership**

The over 50 percent ownership test applies to the total combined voting power of all classes of stock entitled to vote or the total value of the corporate stock. Direct and indirect ownership is considered pursuant to IRC §958. Constructive ownership rules are also used, except the attribution rules under IRC §318 are used applying 10 percent rather than 50 percent.

For purposes of the voting power test, only the voting shares of stock are considered. To prevent manipulation of CFC status by corporations simply issuing nonvoting stock to major investors, the value test was added to the definition of a CFC by the Tax Reform Act of 1986. For purposes of the value test, all shares of stock are considered.

Example 1:

Assume Cinder Corporation, a foreign corporation, is owned 45 percent by Ash, a United States corporation; 9 percent by Bob, a United States person; and 46 percent by Fuego, a foreign corporation. Is Cinder a CFC?

No. Because Bob owns less than 10 percent of Cinder, he does not meet the definition of a United States shareholder. Thus, the total United States shareholder ownership is only 45 percent. Cinder is not a CFC.

Example 2:

Assume the same facts as in Example 1, except assume Ash owns 50 percent. Is Cinder a CFC?

No. Because Bob owns less than 10 percent of Cinder, he does not meet the definition of a United States shareholder. The total United States shareholder ownership is only 50 percent. The United States shareholder ownership does not exceed 50 percent. Cinder is not a CFC.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### Example 3:

Assume the same facts as in Example 1, except assume Bob owns 10 percent. Is Cinder a CFC?

Yes. Bob owns 10 percent of Cinder so he now meets the definition of a United States shareholder. The total United States shareholder ownership is now 55 percent. The United States shareholder ownership exceeds 50 percent. Cinder is a CFC.

### **5. Deemed Control**

TR §1.957-1(b) and TR §1.957-1(c) provide circumstances under which United States ownership is "deemed" to be over 50 percent, even though actual ownership is 50 percent or less. This issue arises often when a United States corporation owns an offshore joint venture. United States shareholders of a foreign corporation will be deemed to hold controlling voting power if:

- a. They have the power to elect, appoint or replace a majority of that body of persons exercising the powers ordinarily exercised by the board of directors of a domestic corporation;
- b. Any person, elected or designated by the United States shareholder(s) where the United States shareholders have the ability to elect or designate exactly one half of such governing body of the foreign corporation, has the power either to cast a vote deciding an evenly divided vote or to exercise the powers ordinarily exercised by such governing body for the duration of any deadlock which may arise; or
- c. The powers, which would ordinarily be exercised by the board of directors of a domestic corporation, are exercised with respect to such foreign corporation by a person whom the United States shareholders have the power to elect, appoint or replace.<sup>10</sup>

Any arrangement made between the foreign corporation and the United States shareholder(s) to shift the formal voting power of the stock away from the United States shareholder(s) will not be considered if in reality the voting power is retained. For example, if there is an agreement either expressed or implied that any shareholder will not vote their stock or will vote it only in a specified manner,



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

then nominal ownership of the voting power will be disregarded and the determination will be made based on any such agreement.<sup>11</sup>

### Example 4:

Milo Corporation, a United States corporation, owns a 49 percent interest in Tosh Enterprises, a foreign corporation. Tosh is formed under the laws of Switzerland. The remaining 51 percent interest in Tosh is owned by persons who are not United States persons. The organization contract of Tosh provides for one manager, Benson, a citizen and resident of Switzerland who is also an officer of Milo in charge of its foreign operations in Switzerland, or any person Milo may at any time appoint to succeed Benson in such capacity. The manager has sole authority with respect to Tosh to exercise powers ordinarily exercised by a board of directors of a domestic corporation. Since Milo has the discretionary power to replace Benson and to appoint his successor as manager, Milo is deemed to have controlling voting power. Thus, Tosh is a CFC.<sup>12</sup>

### Example 5:

Mustafa Corporation, a foreign corporation, is authorized to issue 100 shares of one class of capital stock. It issues 45 shares to Payo Corporation, a domestic corporation; 45 shares to Peppy Corporation, a foreign corporation; and 10 shares to the Bank of Kasey, a foreign bank. The Bank lends \$3 million to finance the operations of Mustafa. In the course of the negotiations, Daniels, an officer of the Bank, and Edwards, an officer of Payo, orally agree that the Bank will vote its stock as Payo directs. By virtue of such an agreement, Payo owns the voting power ostensibly owned by the Bank. Payo is deemed to have controlling voting power. Mustafa is a CFC.<sup>13</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### Example 6:

USCO, a domestic corporation, attempts to reduce its ownership in a wholly-owned Panamanian subsidiary by having the subsidiary issue one voting share of preferred stock for each share of common stock outstanding to foreign investors. The foreign investors agree to exercise their voting rights at the direction of USCO in exchange for a constant rate of return resembling interest. Because USCO effectively retained control of the subsidiary and there is no indication that the foreign investors will ever exercise their voting rights independently, USCO is deemed to have controlling voting power. The Panamanian subsidiary is a CFC.<sup>14</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **d. Application Of Unity**

As discussed in Chapter 2, Water's-Edge Manual, a CFC with subpart F income can be partially combined with the water's-edge group. However, before a CFC can be combined with the water's-edge group, the CFC must be unitary with the water's-edge group. Because federal rules classify a CFC based strictly on all United States ownership, related or unrelated, a United States shareholder owning at least 10 percent of the stock in a CFC may report a deemed dividend for subpart F income on its federal return. Differences between the federal and state filing groups will arise.

#### Example 7:

Silo Corporation, a United States corporation, owns 75 percent of Filo Company, a foreign corporation. Filo is a CFC with subpart F income. Thus, Silo must report on its federal return a deemed dividend of 75 percent of Filo's subpart F income. However, for California purposes, Filo is not unitary with Silo. In this case, income is reportable to Silo for federal purposes, while Filo is not combinable with Silo for state purposes.

#### Example 8:

Luz Company, a foreign corporation, is owned 40 percent by Sun Corporation, 35 percent by Dial Corporation and 25 percent by Sole, a foreign corporation. Both Sun and Dial are domestic corporations. Sun, Dial and Sole are unrelated corporations. Luz is a CFC with subpart F income of \$200,000.

For federal purposes, Sun must report \$80,000 ( $\$200,000 \times 40\%$ ) as a deemed dividend. Dial must also report a deemed dividend of \$70,000 ( $\$200,000 \times 35\%$ ) on its federal return. However, for California purposes, unity of ownership does not exist and Luz cannot be combined with Sun or Dial.

For water's-edge purposes, the standard unity tests apply. However, as discussed in Chapter 2, Water's-Edge Manual, for income years beginning prior to January 01, 1994, RTC §25110(b)(1) stated that more than 50 percent of the stock must be owned or controlled by any one bank, corporation or person in order for an "affiliated" bank or corporation to be includible in the water's-edge combined report. Thus, for income years beginning on or after January 01, 1988,

## **CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

through income years beginning prior to January 01, 1994, the affiliation test could not be met with multiple owners for water's-edge taxpayers.

For income years beginning on or after January 01, 1994, RTC §25110(b) was amended and currently states that "affiliated" banks or corporations are defined by reference to RTC §25105. Thus, for income years beginning on or after January 01, 1994, the RTC §25105 ownership standard applies to both worldwide and water's-edge taxpayers.<sup>15</sup> Refer to Section 2.1, Water's-Edge Manual for a more detailed discussion of this issue.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### e. *Summary*

If a foreign corporation has at least one United States shareholder and has a total United States ownership that exceeds 50 percent, then that foreign corporation is a CFC.

The ability to recognize a CFC is an important step in the audit of a water's-edge return. The CFC status of a foreign corporation must first be determined before the Subpart F provisions can be applied. After determining that the foreign corporation is a CFC, then the income of the CFC must be analyzed to determine whether any of its income satisfies the definition of subpart F income.

If the CFC has subpart F income, a deemed dividend must be reported by the United States shareholders for federal purposes. The subpart F provisions allow the United States to tax United States shareholders on certain net income earned by their foreign corporations. This income is taxable to the United States shareholder whether or not the income is actually distributed.

For California purposes, if a unitary CFC has subpart F income, then the CFC's income and factors are partially included based on the ratio of the CFC's subpart F income to the CFC's earnings and profits for the taxable year.

Section 9.2, Water's-Edge Manual discusses the federal and state differences in treatment of a CFC with subpart F income and defines subpart F income.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **Footnotes**

1. E.I. DuPont de Nemours Company v. United States, 78-1 USTC 9374, adopt'g CtCI trial judge's decision, 79-2 USTC 9633, 608 F2d 445 (CtCI 1979), cert. denied, 445 US 962 (1979).
2. Treasury Regulation (TR) §1.957-1(a).
3. TR §1.951-1(a).
4. TR §1.951-1(g)(1).
5. TR §1.957-4(a).
6. Internal Revenue Code §953(c)(1)(A).
7. TR §301.7701-5.
8. TR §1.957-3(b)(2).
9. TR §1.957-3(a).
10. TR §1.957-1(b)(1).
11. TR §1.957-1(b)(2).
12. TR §1.957-1(c), Example #4.
13. TR §1.957-1(c), Example #7.
14. Garlock, 74-1 USTC 9141 (CA-2).
15. Senate Bill No. 1805, Chapter 1243, enacted September 30, 1994, effective for income years beginning on or after January 01, 1994.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### Section 9.2 Controlled Foreign Corporations Subpart F Income

#### ***Contents:***

- a. Federal Treatment Of A Controlled Foreign Controlled With Subpart F Income
- b. California Treatment Of A Controlled Foreign Controlled With Subpart F Income
- c. Subpart F Of The Internal Revenue Code
- d. Types Of Subpart F Income
  - 1. Income From Insurance Of United States Risks
  - 2. International Boycott Income
  - 3. Income From Illegal Bribes And Kickbacks
  - 4. Income From Internal Revenue Code §901(J) Foreign Countries
- e. Summary

#### ***References:***

Revenue and Taxation Code §25110(a)(7)  
California Code of Regulations §25110(d)(2)(F)  
Internal Revenue Code §952  
Internal Revenue Code §901(j)  
Internal Revenue Code §999

#### ***Training Objectives:***

Section 9.1, Water's-Edge Manual discussed the definition of a controlled foreign corporation (CFC). Once a foreign corporation meets the definition of a CFC, then its income must be analyzed to determine if its income meets the definition of subpart F income. This section of the Water's-Edge Manual describes the federal and California treatment of a CFC with subpart F income. This section also provides an analysis of subpart F of the Internal Revenue Code (IRC). At the end of this section, you will have an understanding of the differences between the federal and California treatment of a CFC with subpart F income and know the definition of subpart F income.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***a. Federal Treatment Of A Controlled Foreign Corporation With Subpart F Income***

For federal purposes, the subpart F income of a CFC is considered to be a deemed dividend on the last day of the CFC's income year. The United States shareholders must report their pro rata share of the CFC's income based on ownership as of the last day of the CFC's income year. The pro rata share is determined by reference to the percentage of the shareholder's stock to the total number of shares outstanding. The deemed dividend is limited to the CFC's current year earnings and profits.

The basic formula for determining the shareholder's pro rata share of subpart F income is:

$$\frac{\text{United States Shareholder's Shares}}{\text{Total Outstanding Shares}} \times \text{Subpart F Income Of the CFC}$$

#### **Example 1:**

Watley, a United States citizen, owns 60 percent of Acme Corporation, a CFC. Acme generates \$10,000 of subpart F income for its taxable year. Watley's pro rata share is \$6,000 [ $\$10,000 \times (60 \text{ United States shares} / 100 \text{ total shares})$ ] and it must be reported as a deemed dividend on his federal return.

#### **Example 2:**

On June 1, 1994, Zippo Corporation, a domestic corporation, acquires from a domestic corporation 80 percent of Zip Corporation, a foreign corporation. Zip has subpart F income of \$225,000 for the 1994 calendar year. How much income must Zippo report on its federal return?

Zip is a CFC for the entire 1994 income year. Even though Zippo only owned Zip for six months of the 1994 calendar year, Zippo owns the stock on the last day of the CFC's income year. Thus, Zippo must report its pro rata share of the entire year's subpart F income. Zippo must report \$180,000 as a deemed dividend [ $\$225,000 \times (365 \text{ CFC days} / 365 \text{ total days}) \times 80\%$ ] on its federal return.



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

Adjustments are required, however, when a foreign corporation does not meet the definition of a CFC for the entire year. An adjustment is made to reflect the number of days during which the corporation is a CFC.

### Example 3:

Jones, a United States citizen, owns 100 percent of Weste, a CFC. On May 26, Jones sells 60 percent of his shares to LaBeau, a French citizen. Weste generates \$10,000 that would qualify as subpart F income for the entire year. Jones is required to report a deemed dividend of \$4,000 [ $\$10,000 \times (146 \text{ CFC days} / 365 \text{ total days}) \times 100\%$ ].<sup>1</sup> After May 26, Weste is no longer a CFC.

### Example 4:

On January 1, 1994, Gott Corporation, a domestic corporation, acquired 45 percent of Forge Corporation, a foreign corporation. The remaining 55 percent was owned by foreign interests. On September 1, 1994, Sam Corporation, a domestic corporation, acquired 10 percent of Forge. As of September 1, 1994, Forge meets the definition of a CFC. Of Forge's \$900,075 total income, \$575,500 qualifies as subpart F income. How much income must both Gott and Sam report in 1994?

Only the subpart F income while Forge is a CFC is considered. Thus, Forge's reportable subpart F income is \$145,058 [ $\$575,500 \times (92 \text{ CFC days} / 365 \text{ total days}) \times 100\%$ ]. Gott must report \$65,276 [ $\$575,500 \times (92 \text{ CFC days} / 365 \text{ total days}) \times 45\%$ ] as a deemed dividend. Sam must report a deemed dividend of \$14,506 [ $\$575,500 \times (92 \text{ CFC days} / 365 \text{ total days}) \times 10\%$ ].

1. Any deemed dividend will increase the corporation's federal basis in the CFC,<sup>2</sup> while any actual dividend distribution will reduce the federal basis.<sup>3</sup> The deemed dividend is limited to the amount of the CFC's current earnings and profits. Earnings and profits are discussed in Chapter 11, Water's-Edge Manual. Refer to that chapter for more information on the calculation of earnings and profits.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***b. California Treatment Of A Controlled Foreign Corporation With Subpart F Income***

Pursuant to Revenue and Taxation Code (RTC) §25110(a)(7), a CFC with subpart F income defined in IRC §952 is included in the water's-edge combined report based on the ratio of subpart F income to earnings and profits for the current income year. This treatment is very different from the federal treatment where the United States shareholder must report its pro rata share of any subpart F income as a deemed dividend. It is important to note that California does not conform to the federal subpart F provisions. Rather, California uses the ratio of subpart F income to current E & P to determine how much of the CFC's income and apportionment factors are includible in the water's-edge combined report. It is also important to note that differences may exist between the subpart F income reported for federal purposes and the subpart F income used for inclusion ratio purposes. The following differences may exist:

1. If the CFC is less than 100% owned by the US shareholder, the subpart F income reported for federal purposes will represent the US shareholders pro rata distribution. For inclusion ratio purposes, 100% of the subpart F income should be included in the numerator.
2. The subpart F income may include amounts that were recharacterized in the current year from the recapture account. For federal purposes, subpart F income that exceeds current E & P is required to be recaptured and recharacterized as subpart F income in future years when current E & P exceeds subpart F income. If the federal subpart F income includes amounts that were recharacterized, this amount should be backed out for purposes of computing the inclusion ratio.
3. The prior year deficit or qualified chain deficit rule may have been used in the calculation of subpart F income for federal purposes. Qualified deficits can be carried over to future years to reduce the current E & P which can result in reduced subpart F income since subpart F income for federal purposes is limited to current E & P. The qualified chain deficit rule is similar to the prior year deficit rule except the deficits from qualified affiliates are used instead of the CFC's own deficits. If subpart F income was reduced because of the prior year deficit rule or the qualified chain deficit rule, then subpart F income must be increased by the amount that was reduced for purposes of calculating the inclusion ratio.
4. The subpart F income for federal purposes may include amounts

**The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated**

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

determined under IRC §951(a)(1)(A)(ii) or (iii), §956 or §956A. Such subpart F income is not included in the computation of the inclusion ratio.

5. Subpart F income may be under reported due to the exclusion of previously taxed income under IRC §959(b). See Part 4 of Section 9.3(c), Water's-Edge Manual for or a more in depth discussion.

The partial inclusion of a CFC in a water's-edge combined report is determined applying the following formulas:

1. Apportionable Current Year Income

$$\begin{array}{rclcl} \text{Subpart F Income} & & \text{California} & & \text{Includible} \\ & & \text{Apportionable} & = & \text{Business} \\ \text{Earnings and Profits} & \times & \text{Net Income} & & \text{Income} \end{array}$$

2. Nonbusiness Current Year Income

$$\begin{array}{rclcl} \text{Subpart F Income} & & \text{California} & & \text{Includible} \\ & & \text{Nonbusiness} & = & \text{Nonbusiness} \\ \text{Earnings and Profits} & \times & \text{Net Income} & & \text{Income} \end{array}$$

3. Apportionment Current Year Factors

$$\begin{array}{rclcl} \text{Subpart F Income} & & \text{Factor} & & \text{Includible} \\ & & & = & \text{Factor} \\ \text{Earnings and Profits} & \times & & & \end{array}$$

Note that the California apportionable net business income used in calculation #1 above is 100 percent of the CFC's California apportionable business income. There is no revision for the taxpayer's ownership percentage. Also, the subpart F income amount used in all the above calculations must also be 100 percent of the CFC's Subpart F income as defined in IRC §952 as opposed to the US

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

shareholders pro rata distribution. Because domestic corporations only report their pro rata share of the subpart F income, they may overlook that 100 percent of the subpart F income must be included in the computation of California's partial inclusion ratio.

The earnings and profits used in all the above calculations are determined using the federal rules in IRC §964. However, IRC §952(c) allows certain prior year deficits to reduce the current year earnings and profits. Because RTC §25110(a)(6) (formerly RTC §25110(a)(7)) looks solely to current year subpart F income and earnings and profits, this prior year deficit rule does not apply for purposes of determining the CFC's partial inclusion percentage. Further, for purposes of this calculation, the reduction for lower tier CFC deficits, known as the "chain deficit rule", is not considered.<sup>4</sup> Refer to Chapter 11, Water's-Edge Manual for the discussion of earnings and profits.

The CFC's ratio of subpart F income to earnings and profits cannot be less than zero and cannot exceed 100 percent.<sup>5</sup> Furthermore, all components of these three calculations are current year amounts.

RTC §25110(a)(7)(A) (formerly RTC §25110(a)(8)(A)) requires that the income and factors of a CFC be taken into account only if the factors would have been taken into account under RTC §25101. Therefore, if the CFC in question does not meet the criteria for inclusion in a combined report (i.e., is not unitary with the water's-edge group), it cannot be included in the water's-edge combined report. Thus, remember the CFC must be unitary with the water's-edge group before it can be included in the combined report.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***c. Subpart F Of The Internal Revenue Code***

The amount reported on the federal return as a subpart F deemed dividend may be more or less than the amount of subpart F income used within the water's-edge inclusion formula. The reason is that subpart F of the IRC encompasses more code sections than those to which California RTC §25110(a)(6) refers. California RTC §25110(a)(6) refers to only one component, which is the component commonly referred to as "subpart F income." To the extent we do not include a component of subpart F income in the inclusion ratio, subpart F income for inclusion ratio purposes will be less than the amount reported on the federal return. To the extent the US shareholder owns less than 100% of the CFC in question, or an item of subpart F income is not included in income of the US shareholder because the income was previously taxed for federal purposes, subpart F income for purposes of computing the ratio will exceed the amounts reported on the federal return. For a more in depth discussion on previously taxed income under IRC 959(b), see Part 4 of Section 9.3(c), Water's-Edge Manual.

Section 951 of Subpart F of the IRC provides that all United States shareholders must include in income their pro rata share of a CFC's earnings from certain types of income. The listed types of income include:

1. Subpart F income, described in IRC §952;
2. A corporation's previously excluded subpart F income withdrawn from investment in less developed countries for the taxable year, described in IRC §955(a)(3);
3. A corporation's previously excluded subpart F income withdrawn from foreign base company shipping operations, described in IRC §955(a)(3);
4. A corporation's increase in earnings invested in United States property, described in IRC §956; and
5. Certain earnings invested in excess passive assets, described in IRC §956A.<sup>6</sup>

RTC §25110(a)(6) only refers to subpart F income as defined in IRC §952. No reference is made in the RTC to IRC §956 or IRC §956A. Accordingly, IRC §956 and IRC §956A subpart F income are not considered for California purposes. In addition, California Code of Regulations (CCR) §25110(d)(2)(F)(ii) specifies that only the subpart F income for the current year is taken into account when

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

determining includible income and factors. As a result of this CCR, subpart F income determined under §955(a)(3) is also not considered for California purposes. Therefore, only subpart F income described in IRC §952, is considered when determining the inclusion percentage of a CFC in the water's-edge combined report.

This can create a trap for the unwary auditor! Do not be tempted to use the federal deemed dividend as the subpart F income amount for the state computation. The federal and state amounts can be significantly different and any differences between subpart F income reported on the federal returns and subpart F income used by the taxpayer in the partial inclusion ratio should be explained by the taxpayer.

The taxpayer's subpart F deemed dividend must be reported on the federal Form 5471. In addition, federal Form 5471, Schedule I, splits the deemed dividend into the above five classifications. However, this amount will be the taxpayer's pro rata share, not necessarily the proper 100 percent amount needed for California purposes. As a starting point, the auditor can review this Schedule I of the federal Form 5471 to determine the reported pro rata subpart F income amount. Also, Worksheet A to the federal Form 5471 provides more detail of the components of the reported subpart F income. Refer to the Forms Appendix at the end of the Water's-Edge Manual for a copy of the federal Form 5471.

**Caution:** The federal Form 5471 is an informational return that must be attached to the federal Form 1120. The taxpayer is subject to penalty if the form is not properly filed. However, the taxpayer is not penalized if the information reported on the federal Form 5471 is inaccurate. This form is used by the Internal Revenue Service (IRS) during an audit but it is not actually audited. Any required adjustments are made to the federal taxable income, not the federal Form 5471. As a result, the accuracy of the federal Form 5471 cannot be relied upon without obtaining and auditing the underlying supporting workpapers.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***d. Types Of Subpart F Income***

IRC §952 lists and describes the income types considered to be subpart F income. The list includes:

1. Income From Insurance, defined in IRC §953;
2. Foreign Base Company Income, defined in IRC §954;
3. International Boycott Income, defined in IRC §952(a)(3);
4. Income From Illegal Bribes and Kickbacks, defined in IRC §952(a)(4); and
5. Income From IRC §901(j) Foreign Countries.

Items of income are characterized in accordance with the substance of the transaction, i.e., substance over form applies. For example, an amount received as "rent", which is actually income from the sale of property, royalties or income from services, would not be characterized as "rent" but instead would be characterized as income from the sale of property, royalties or income from services, respectively. Also, local law is not controlling in the characterizing an item of income.<sup>7</sup>

Each of the above five types of income, with the exception of Foreign Base Company Income (FBCI), is described briefly below. FBCI is discussed in Section 9.3, Water's-Edge Manual. Section 9.3, Water's-Edge Manual will also discuss the allocation of expenses to the identified gross subpart F income. At this point, the discussion below only addresses gross income.

#### ***1. Income From Insurance***

Subpart F income includes income from premiums or commissions from any reinsurance or the issuing of any insurance or annuity contracts in connection with property located outside of the CFC's country of incorporation; if the income would normally be taxed under Subchapter L of the IRC and if the income were earned by a domestic corporation.

Treasury Regulation §1.952-2(a)(2) and Treasury Regulation §1.953 provide guidelines for calculating what amount of premium is attributable to United States risks and how it is taxed pursuant to the provisions of IRC §953 in effect prior to changes that resulted from the Tax Reform Act of 1986 (TRA86)<sup>8</sup>. These

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

regulations provide a priority of application for the insurance income. If the CFC would be considered an insurance company under the rules of Subchapter L of the IRC, then its income is first determined pursuant to IRC §953. (For income years beginning prior to 1987, only insurance of property located in the United States or owned by residents of the United States was considered IRC §953 income. TRA86 extended the IRC §953 rules to insurance of property located outside the CFC's country of incorporation.) Regulations reflecting the current code section are proposed but have no effect until they become finalized.

IRC §953 and its regulations apply only to the CFC's income and deductions attributable to the reinsuring and issuing of insurance and annuity contracts. This is the case whether or not the CFC is considered a true insurance company or a "non-insurance company". The income not related to reinsurance or insurance activity, such as interest income and passive investment income, would remain subject to the general FBCI rules provided by IRC §954.

Regardless, any premiums attributable to the reinsuring and issuing of insurance or annuity contracts in connection with risks located in the CFC's home country generally are not treated as subpart F income.<sup>9</sup>

Because of three court cases the IRS lost in 1992, (Sears, Roebuck & Co., AMERCO and The Harper Group), the IRS is no longer addressing whether or not an insurance CFC is a "non-insurance company" or a "captive". Instead, the IRS has shifted the focus of its audit, to determining whether or not the CFC's income is subpart F income.

For California purposes, whether on a worldwide or water's-edge basis, the department has ruled that an insurance company cannot be included in a combined report. Nor can an income-based tax be assessed on an insurance company on a separate company basis.<sup>10</sup> Thus, this type of subpart F income, income from insurance activities is generally not relevant for our purposes because an insurance company CFC cannot be combined.

### ***2. International Boycott Income***

International boycott income (IBI) was added to subpart F of the IRC by the Tax Reform Act of 1976. If a CFC participates in an international boycott, defined by IRC §999, then the income earned in connection with the boycott participation is



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

subpart F income. This occurs when a United States business agrees to cooperate or participate with certain foreign countries in an international boycott, based upon nationality or religion. Otherwise, the United States business is denied the opportunity to conduct business with that country.

IBI is defined as the income of a CFC (except insurance from United States risks and FBCI), which is determined from operations in or related to any foreign country which requires participation in or cooperation with an international boycott as a condition of doing business within that country or with the government, a company or a national of that country. For example, a CFC, which participates in an international boycott, agrees not to do business with a specific country, such as Israel, in order to do business with another country, such as Saudi Arabia.

The amount of IBI treated as subpart F income is determined by computing the amount of the CFC's IBI, excluding any amount that would otherwise be includable as subpart F income, and excluding any ECI. The remaining amount is then multiplied by the international boycott factor (IBF). The IBF is the ratio of the worldwide operations of the CFC associated with carrying on or participation in an international boycott to the total worldwide income.<sup>11</sup>

### Example 5:

Fuego Company, a CFC, has total worldwide income of \$2,430,000. Fuego has income earned in connection with an international boycott of \$1,847,000. Of this amount, \$47,000 relates to income from an IRC §901(j) foreign country and \$850,00 is FBCI. What is Fuego's IBI to be multiplied by the IBF? What is the IBF? What is Fuego's reportable subpart F income?

The IBI to be multiplied by the IBF is \$950,000 (\$1,847,000 less \$47,000 less \$850,000). Fuego's IBF is 76% (\$1,847,000/\$2,430,000). Fuego's reportable subpart F income is \$1,619,000 (FBCI of \$850,000; IRC §901(j) foreign country \$47,000; and IBI of \$722,000 (\$950,000 X 76%).

Quarterly, the United States Treasury Department publishes a listing of countries that require participation in, or cooperation with, an international boycott. The current list as of October 06, 1994, includes: Bahrain, Iraq, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, United Arab Emirates and the Republic of Yemen.<sup>12</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

United States shareholders of CFCs that participate in an international boycott or do business in a listed country must attach federal Form 5713 to their federal tax return. This form contains a section detailing the calculation of the IBI. Refer to the Forms Appendix at the end of the Water's-Edge Manual for a copy of the federal Form 5713.

### ***3. Income From Illegal Bribes And Kickbacks***

Subpart F income includes an amount equal to the payment of any illegal bribes, kickbacks or other payments paid by or on behalf of the corporation during the taxable year to an official, employee or agent in fact of a government. The principals of IRC §162(c) and the regulations thereunder apply, i.e., is it an ordinary and necessary business expense?

The fair market value of an illegal payment made in the form of property or services is also considered as an illegal payment. IRC §952(a) goes on to state that the payments considered here are payments which would be unlawful under the Foreign Corrupt Practices Act of 1977 (FCPA77).<sup>13</sup> Therefore, the payments would not be deductible if the payor were a United States person.

In general, the FCPA77 provides that it is unlawful for any domestic concern "to make use of the mails or any means or instrumentality of interstate commerce corruptly" in furtherance of an offer, payment, promise to pay, or the authorization of the payment of any money, offer, gift, or promise to give, or the authorization of the giving of anything of value to various foreign officials, foreign political parties or officials thereof, or any other persons, to influence or induce acts or decisions, or to induce the use of influence, in order to assist the concern in obtaining or retaining business for or with any person.

The statute covers payments made to foreign officials for the purpose of obtaining business or influencing legislation or regulations. The statute does not, however, cover so-called "grease payments", such as payments for: expediting shipments through customs; placing a transatlantic telephone call; securing required permits; or obtaining adequate police protection. The statute does not apply even if these transactions involve merely receiving the proper performance of duties.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

Note that the amount of these payments will not reduce the earnings and profits of a CFC.<sup>14</sup> For federal purposes, the significance of the effect on earnings and profits is that there is more available earnings and profits with which to determine the potential dividend from other types of subpart F income for federal purposes. For California purposes, the ratio of inclusion may be affected.

### ***4. Income From Internal Revenue Code §901(J) Foreign Countries***

For income years beginning on or after January 1, 1987, subpart F income includes any income earned in a country in any period during which IRC §901(j) applies. IRC §901(j) disallows the foreign tax credit or the deduction of taxes to any United States business operating in certain foreign countries. IRC §901(j) provides that the certain foreign countries are those where the United States government:

1. Does not recognize the foreign government, unless that government is otherwise eligible to buy articles or services under the Arms Export Control Act;
2. Has severed diplomatic relations, formally or for all practical purposes informally; or
3. Has designated the country as one which repeatedly provides support for acts of international terrorism.

The applicable period begins on the later of January 1, 1987, or six months after the foreign country falls into one of the above categories, and ends on the date the Secretary of State certifies to the Secretary of the Treasury that the country is no longer in one of the above categories.<sup>15</sup>

Currently, there are 13 sanctioned (IRC §901(j)) countries. These countries are listed in Revenue Ruling 92-63A. The ruling also provides the applicable IRC §901(j) period. The list includes: Afghanistan, Albania, Angola, Cambodia, Cuba, Iran, Iraq, Libya, North Korea, South Africa, Syria, Vietnam and the Republic of Yemen.<sup>16</sup> Note that in addition to the countries listed in the ruling and the respective IRC §901(j) applicable periods, IRC §901(j)(2)(C) contains a special rule with an additional applicable period for South Africa.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### e. *Summary*

This section discussed the federal rules for treating subpart F income as a deemed dividend to the United States shareholders of a CFC. This section also discussed the California treatment of a CFC with subpart F income. While there is a different treatment for state purposes, a working knowledge of the federal rules for CFCs and subpart F income is important. The five types of income within subpart F of the IRC were listed and discussed. In addition, the five types of income or payments that are considered to be subpart F income by definition within IRC §952 were listed and discussed, with the exception of FBCI.

The auditor will need to pay particular attention to water's-edge taxpayers with CFCs. While the deemed subpart F dividend reported for federal purposes **will not** be included as income in the water's-edge combined report, it is used in the calculation of the inclusion ratio to determine the amount of income, property, payroll and sales of the CFC to include the water's-edge combined report. Refer to Section 9.2(c), Water's-Edge Manual for a discussion of the differences that may exist between the subpart F income reported for federal purposes and the subpart F income included in the numerator of the inclusion ratio.

Section 9.3, Water's-Edge Manual will discuss in more depth FBCI, the most common type of subpart F income, and the process of allocating expenses to the applicable gross subpart F income.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **Footnotes**

1. Treasury Regulation §1.951-1(b)(2), Example #2.
2. Internal Revenue Code (IRC) §961(a).
3. IRC §961(b)(1).
4. California Code of Regulations (CCR) §25110(d)(2)(F)(i).
5. CCR §25110(d)(2)(F)(ii).
6. Public Law (PL) 103-66, Omnibus Budget Reconciliation Act of 1993, effective for income years beginning on or after September 30, 1993, 107 Stat. 311.
7. Temporary Treasury Regulation §1.954-1T(e).
8. PL 99-514, Tax Reform Act of 1986, effective for income years beginning on or after January 1, 1987, 1986-3 Cumulative Bulletin (CB), page 1.
9. Proposed Treasury Regulation §1.953-1(a).
10. Legal Ruling 385.
11. IRC §999(c)(1).
12. Treasury Notice, 46,429.
13. PL 95-213, 91 Stat. 1494 (1977).
14. Treasury Regulation §1.964-1(a).
15. IRC §901(j)(2)(B).
16. Revenue Ruling 92-63A, 1992-2 CB, page 197.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### Section 9.3 Controlled Foreign Corporations Foreign Base Company Income

#### ***Contents:***

- a. Foreign Base Company Income
- b. FBCI Exceptions And Special Rules
  - 1. De Minimis Rule
  - 2. High Foreign Tax Rule
  - 3. Full Inclusion Rule
  - 4. Anti-Abuse Rule
  - 5. Comprehensive Example – Exceptions and Special Rules
- c. Foreign Personal Holding Company Income
  - 1. In General
    - A. Sale or Exchange of Property
    - B. Commodity Transactions
    - C. Foreign Currency Transactions
    - D. Income Equivalent to Interest
  - 2. FPHCI Exceptions
    - A. Dividend and Interest Income
    - B. Rents and Royalties
    - C. Gains
  - 3. Passive Foreign Investment Companies
  - 4. Multi-Tiered CFCs and IRC §959(b)
- d. Foreign Base Company Sales Income
  - 1. In General
  - 2. FBCSales Same Country Exceptions
    - A. Manufacture of Goods Within the Same Country
    - B. Consumption of Goods Within the Same Country
  - 3. FBCSales Manufacturing Exception
    - A. Substantial Transformation Test
    - B. Substantial Operations Test
  - 4. Treatment of Certain Branch Income
  - 5. Contract Manufacturing
  - 6. Income Allocation Rules
- e. Foreign Base Company Services Income
  - 1. In General

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

- 
- 2. FBCServices Exceptions
  - 3. Substantial Assistance Rule
  - f. Foreign Base Company Shipping Income
    - 1. In General
    - 2. FBCShipping Exceptions
  - g. Foreign Base Company Oil Related Income
    - 1. In General
    - 2. FBCO Exceptions
  - h. Adjusted Net FBCI
  - i. Expense Allocation Rules
    - 1. In General
    - 2. Allocation Rules – Examples
  - j. California Audit Considerations
  - k. Summary

### ***References:***

Internal Revenue Code §954  
Treasury Regulations §1.951-§1.954A  
Revenue and Taxation Code §25110(a)(7)  
California Code of Regulations §25110(d)(2)(F)

### ***Training Objectives:***

Section 9.2, Water's-Edge Manual discussed the differences between the federal and California treatment of a controlled foreign corporation (CFC). It also discussed the definition of subpart F income. This section of the Water's-Edge Manual describes foreign base company income, the most common type of subpart F income. This section will also discuss the rules used to allocate expenses to identified foreign base company income.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **a. Foreign Base Company Income (FBCI)**

Section 9.2, Water's-Edge Manual discussed the different categories of subpart F income defined by Internal Revenue Code (IRC) §952, except FBCI. IRC §954(a) defines the various types of FBCI, which is the most common type of subpart F income. FBCI is somewhat different from the other subpart F income categories because additional requirements must be satisfied before FBCI can be classified as subpart F income.

There are five categories of FBCI. Each will be discussed separately within this chapter. These categories include:

1. Foreign Personal Holding Company Income, determined pursuant to IRC §954(c);
2. Foreign Base Company Sales Income, determined pursuant to IRC §954(d);
3. Foreign Base Company Services Income, determined pursuant to IRC §954(e);
4. Foreign Base Company Shipping Income, determined pursuant to IRC §954(f); and
5. Foreign Base Company Oil Related Income, determined pursuant to IRC §954(h).



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***b. FBCI Exceptions And Special Rules***

IRC §954(b) describes certain rules that apply to FBCI and insurance income. These additional tests do not apply to the other categories of subpart F income, international boycott income, income from illegal bribes and kickbacks, and income from IRC §901(j) foreign countries. These additional tests include a high foreign tax rule<sup>1</sup>, a de minimis rule and a full inclusion rule.<sup>2</sup>

California conforms to these additional tests.<sup>3</sup> Even though California does not assess a franchise tax against insurance companies, for purposes of these three additional tests, insurance income is considered. However, if the result of any of these tests is to include income for federal purposes from a bona fide insurance company, we would not be able to assess a tax against the insurance company nor include the insurance company in the California combined report.

#### ***1. De Minimis Rule***

The de minimis exception is described by IRC §954(b)(3)(A) and allows a foreign corporation to have a minimal amount of FBCI and insurance income without becoming subject to the subpart F provisions. If the sum of the FBCI and the insurance income falls below the following minimum amount, then the FBCI and the insurance income are not considered to be subpart F income. Thus, this rule is used to determine whether or not the CFC's FBCI and insurance income are subpart F income.

The de minimis rule provides that none of the CFC's gross income is treated as subpart F income if the sum of the FBCI and the gross insurance income of a CFC is less than the lesser of:

1. 5 percent of a CFC's total gross income; or
2. \$1,000,000.

Gross insurance income is defined as any item of gross income taken into account pursuant to IRC §953.<sup>4</sup> For purposes of applying this de minimis exception, if the CFC's currency is not the United States dollar, then the \$1,000,000 threshold must be translated into the functional currency of the CFC using the weighted average exchange rate.<sup>5</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

Example 1:

Flint Company, a CFC operating in South America, has the following income for the income years ended in 1994 and 1995:

<b>FLINT COMPANY</b>	<b>1994</b>	<b>1995</b>
Non-Subpart F Income	\$13,850,245	\$35,678,990
FBCI	560,000	987,000
Insurance Income	45,000	50,000
Total Gross Income	\$14,455,245	\$36,715,990

Does Flint Company meet the de minimis rule in 1994? 1995?

<b>De Minimis Exception</b>	<b>1994</b>	<b>1995</b>
Gross Income	\$14,455,245	\$36,715,990
Threshold Percentage	.05	.05
Threshold Amount	722,762	1,835,800
Or	1,000,000	1,000,000
The lesser of the two	722,762	1,000,000

**Answer:** For 1994, because Flint's FBCI and insurance income of \$605,000 is less than the threshold amount of \$722,762, Flint meets the de minimis exception. As a result, the \$605,000 of FBCI and insurance income is disregarded. Flint has no subpart F income.

For 1995, because Flint's FBCI and insurance income of \$1,037,000 is more than the threshold amount of \$1,000,000, Flint does not meet the de minimis exception. As a result, Flint has FBCI of \$987,000 and insurance income of \$50,000, which are considered to be subpart F income.

### **2. High Foreign Tax Rule**

The high foreign tax rule, described in IRC §954(b)(4), provides that FBCI and insurance income can be excluded from subpart F income if the income is subjected to an effective foreign income tax rate that is greater than 90 percent of the maximum United States tax rate and the taxpayer establishes this to the

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

satisfaction of the Secretary.<sup>6</sup> In general, if the high foreign tax rule is met, the CFC is not considered to be organized primarily to avoid United States income tax. If the high foreign tax rule is met, the taxpayer has the option of including this income as subpart F income or making an election to exclude the income. Thus, if the high foreign tax rule is met and the taxpayer makes an election to exclude the income, the CFC's income will not be considered subpart F income.

Therefore, until the maximum United States income tax rate changes, if foreign jurisdictions impose a tax with an effective income tax rate that exceeds 31.5 percent ( $35\% \times 90\% = 31.5\%$ ) for income years beginning on or after January 01, 1993, then the income is excludible from FBCI or insurance income. For income years beginning prior to January 01, 1993, the effective foreign income tax rate must exceed 30.6 percent ( $34\% \times 90\% = 30.6\%$ ).

This rule applies separately to each "item of income" received by the CFC. The following are considered separate "items of income" for purposes of calculating the high tax exception.

1. Foreign base company sales income.
2. Foreign base company service income.
3. Foreign base company shipping income.
4. Foreign base company oil related income.
5. Full inclusion foreign base company income.
6. Foreign personal holding company income.

Foreign personal holding company income is further broken down into the following categories.

1. Dividends, interest, rents, royalties and annuities.
2. Gains from certain property transactions.
3. Gains from commodities transactions.
4. Foreign currency gains over losses.
5. Income equivalent to interest.

The above income items must be further broken down into the separate categories of income, which are referred to as "baskets", listed under IRC §904(d). For example, if a CFC received a dividend which qualifies as a 10/50 dividend under IRC §904(d)(1)(E), it will also be considered a separate "item of income".

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

The application of the high tax exception to passive foreign personal holding company income is subject to a consistency rule. If an election is made to exclude an item of passive foreign personal holding company income from subpart F income under the high tax exception, the election must be consistently made with respect to all items of passive foreign personal holding company income eligible to be excluded.<sup>7</sup>

The Treasury Regulations provide that similar items of income may be grouped if they fall into the same category of FBCI and the same foreign tax credit limitation basket as defined by IRC §904(d).<sup>8</sup> For example, all service income received by a CFC is treated as a single item of income for purposes of this rule regardless of whether the income is earned in more than one foreign country.

### Example 2:

Foe Corporation is a CFC operating in Italy. In 1994 Foe has dividend income of \$69,000, for which Foe paid a total of \$10,350 of Italian income tax. Foe also has service income of \$112,000, for which Foe paid \$28,960 of French income tax and \$12,845 of German income tax. How much FBCI does Foe have to report?

Answer: The effective tax rate paid with respect to the dividend income was 15 percent ( $\$10,350/\$69,000 = 15\%$ ). Because this 15 percent rate does not exceed 31.5 percent, the \$69,000 of dividend income *is* considered to be FBCI. The effective tax rate paid to France and Germany was 37 percent [ $(\$28,960 + \$12,845)/\$112,000 = 37\%$ ]. Because this 37 percent rate exceeds 31.5 percent, at the taxpayer's option the \$112,000 of service income *is not* considered to be FBCI. In 1994 Foe must report subpart F income of \$69,000.

Note that the high foreign tax rule applies to all types of FBCI with the exception of foreign base company oil-related income. Also, the relevant foreign income tax rate is the effective tax paid. The effective tax rate is computed by dividing the total tax paid or accrued with respect to the item of income by the amount of that item of income.<sup>9</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

### 3. Full Inclusion Rule

The full inclusion rule is described in IRC §954(b)(3)(B) and provides that if the sum of the FBCI and the gross insurance income exceeds 70 percent of the CFC's total gross income, then 100 percent of the CFC's income constitutes either FBCI or insurance income. Again, gross insurance income is defined as any item of gross income taken into account pursuant to IRC §953.<sup>10</sup>

If the full inclusion rule is met, then 100 percent of the CFC's gross income must be included as subpart F income. Treasury Regulation §1.954-1T(b)(1)(i) clarifies that the insurance income would remain classified as insurance income. All other remaining gross income would be classified as FBCI.

Example 3:

Fleet Company, a CFC operating in Argentina, has the following income for the income years ended in 1994 and 1995:

<b>FLEET COMPANY</b>	<b>1994</b>	<b>1995</b>
Non-Subpart F Income	\$3,850,245	\$5,678,990
FBCI	8,560,000	15,987,000
Insurance Income	4,575	5,000
Total Gross Income	\$12,414,820	\$21,670,990

Does Fleet Company meet the full inclusion rule in 1994? 1995?

<b>Full Inclusion Rule</b>	<b>1994</b>	<b>1995</b>
Gross Income	\$12,414,245	\$21,670,990
Threshold Percentage	.70	.70
Threshold Amount	\$8,690,374	\$15,169,693
FBCI & Insurance Income	\$8,564,575,	\$15,992,000

Answer: For 1994, because Fleet's FBCI and insurance income of \$8,564,575 is less than the threshold amount of \$8,690,374, Fleet does not meet the full

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

inclusion rule. As a result, Fleet has FBCI of \$8,560,000 and insurance income of \$4,575 to report as subpart F income.

For 1995, because Fleet's FBCI and insurance income of \$15,992,000 is more than the threshold amount of \$15,169,693, Fleet does meet the full inclusion rule. As a result, Fleet has FBCI of \$21,665,990 (\$15,987,000 + \$5,678,990) and insurance income of \$5,000, totaling \$21,670,990 of subpart F income to report.

### 4. Anti-Abuse Rule

There is an anti-abuse rule that applies to both the de minimis rule and the full inclusion rule.<sup>11</sup> The income of two or more CFCs is aggregated and treated as a single corporation if one of the principal purposes for organizing multiple CFCs is to avoid the effect of these two rules. The principal purpose of having more than one CFC does not have to be of first importance.

Avoidance is presumed if the CFCs are related corporations and if the:

1. Activities carried on, or the assets held, were previously carried on or held by a single CFC and the United States shareholders are substantially the same; or
2. CFCs carry on business, a financial operation or a venture as partners in a partnership that is related with respect to each CFC; or
3. Activities carried on by the CFCs would constitute a single branch pursuant to IRC §367 if carried on by a United States person.

Example 4:

Future 2000, Inc., is the sole shareholder of two CFCs, Tech-Em Corporation and Sci-Fi, Inc. The two CFCs have the same income year end and equally own a foreign joint venture. Each CFC derives FBCI from the joint venture. Tech-Em has gross income of \$18,000,000 and FBCI of \$800,000. Sci-Fi has gross income of \$19,000,000 and FBCI of \$875,000. Does the anti-abuse rule apply here?

<u>De Minimis Exception</u>	<u>Tech-Em</u>	<u>Sci-Fi</u>	<u>Aggregated</u>
Gross Income	\$18,000,000	\$19,000,000	\$37,000,000

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

Threshold Percentage	.05	.05	.05
Threshold Amount	\$900,000	\$950,000	\$1,850,000
Or,	\$1,000,000	\$1,000,000	\$1,000,000
The Lesser of the two	\$900,000	\$950,000	\$1,000,000

Answer: Before applying the anti-abuse rule, for Tech-Em, because its FBCI of \$800,000 is less than the threshold amount of \$900,000, Tech-Em would meet the de minimis exception. As a result, the \$800,000 of FBCI would be disregarded and Tech-Em would have no subpart F income. For Sci-Fi, because its FBCI of \$875,000 is less than the threshold amount of \$950,000, Sci-Fi would meet the de minimis exception. As a result, the \$875,000 of FBCI would be disregarded and Sci-Fi would have no subpart F income.

However, after applying the anti-abuse rule and the totals are aggregated, the results change. Because the aggregated FBCI of \$1,675,000 (\$800,000 + \$875,000) is more than the threshold amount of \$1,000,000, the two CFCs do not meet the de minimis exception. As a result, for Tech-Em the \$800,000 of FBCI is considered and Tech-Em would have subpart F income. For Sci-Fi, the \$875,000 of FBCI is considered and Sci-Fi would also have subpart F income.

### 5. Comprehensive Example - Exceptions And Special Rules

Example 5:

Le Corp, a CFC organized in France, has gross income from manufacturing of \$3.9 million and gross dividend income of \$100,000. Le Corp pays an effective income tax rate of 15 percent in France. Petre Compania, a related CFC in Italy, has gross income of \$900,000 from the sales of goods it purchases from Le Corp. Of Petre's total sales, 80 percent were sold to unrelated persons outside of Italy. The remaining 20 percent were sold to unrelated person in Italy. Petre pays an effective income tax rate of 10 percent in Italy. What is Le Corp's and Petre's total FBCI?

For Le Corp:

Gross Income from	\$3,900,000
Manufacturing	

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

Dividend Income	<u>100,000</u>
-----------------	----------------

Total Gross Income	<u>\$4,000,000</u>
--------------------	--------------------

Le Corp is manufacturing. Thus, the income from its manufacturing activity meets an exception and the income is not FBCI. (Refer to the discussion at Part 3 of Section 9.3(d), Water's-Edge Manual.) The next step would be to apply the additional tests applicable to FBCI. Does Le Corp meet the de minimis rule?

### **De Minimis Rule Calculation**

5% X \$4,000,000 = \$200,000

The lesser is  
\$200,000

Or \$1,000,000

Answer: Le Corp's dividend income of \$100,000 is less than the \$200,000 de minimis threshold amount. Thus, the de minimis rule is met. The \$100,000 is not included as FBCI. Le Corp has no FBCI.

### **For Petre Compania**

Gross Income – Sales	\$900,000
Sales within Italy - Not FBCS Sales	<u>(180,000)</u>
Total FBC Sales	\$720,000

Sales of \$180,000 remained in Italy. Thus, these sales are not considered FBCSales because Petre is organized in Italy. The next step would be to apply the additional tests applicable to FBCI. Does Petre meet the de minimis rule?

### **De Minimis Rule Calculation:**

5% X \$900,000 = \$45,000

The lesser is  
\$45,000

Or, \$1,000,000

Result: Petre's sales income of \$720,000 is more than the \$45,000 de minimis threshold amount. Thus, the de minimis rule is not met. The \$720,000 is not excludible.

The next step is whether or not Petre meets the full inclusion rule.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### Full Inclusion Rule Calculation:

$$70\% \times \$900,000 = \$630,000$$

Result: The \$720,000 of FBC Sales is greater than the \$630,000 threshold amount. Petre meets the full inclusion rule. Thus, 100 percent of Petre's gross income, \$900,000, must be included as FBCSales.

The next step is whether or not Petre meets the high foreign tax rule. Does Petre meet the high foreign tax rule?

High Foreign Tax Rule: Petre pays a foreign tax with an effective tax rate of 10 percent. The rate must exceed 31.6 percent in order to meet this test and it does not. Petre does not meet the high foreign tax rule. The \$900,000 is not excludable.

Conclusion: Petre does not meet the de minimis rule. Further, Petre does not meet the high foreign tax rule. Thus, the FBCSales cannot be excluded because of these two tests. However, Petre does meet the full inclusion rule. Thus, Petre has FBCSales of \$900,000 to report as subpart F income rather than \$720,000 of FBCSales.

Recall that for certain types of insurance income IRC §953 takes precedence over IRC §954 should the income meet the definition of both code sections. IRC §953 addresses both premium and investment income of an insurance company and premium income derived from a "non-insurance company". The significance of the precedence rule is that if the income meets the definition of IRC §953, the income is subpart F income. Therefore, the taxpayer cannot use the high foreign tax rule pursuant to IRC §954(b)(4) to exclude the income as subpart F income. However, the taxpayer can use the de minimis rule to exclude the income from the subpart F income. Further, the full inclusion rule still applies.

Refer to [Exhibit 9.3A](#), which contains a summary of subpart F of the IRC.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***c. Foreign Personal Holding Company Income***

#### ***1. In General***

The first type of FBCI is foreign personal holding company income (FPHCI), which includes gross income that is typically classified as passive investment income. FPHCI generally includes:

1. Dividends;
2. Interest;
3. Royalties;
4. Rents;
5. Annuities;
6. Excess gains over losses from the sale or exchange of property:
  - i. Which gives rise to income described by item #1 through #5, above, (excluding property which gives rise to active business rents or royalties received from unrelated persons);
  - ii. Which is an interest in a trust, partnership or REMIC; or,
  - iii. which does not give rise to any income.
7. Excess gains over losses from commodity transactions (including futures, forward and similar transactions);
8. Excess of foreign currency gains over foreign currency losses, as defined in IRC §988(b);
9. Income equivalent to interest, including commitment fees for loans actually made;
10. Income from notional principal contracts. However, income, gain, deductions or loss from a notional principal contract that hedges an item described in another category is taken into account under the other category. This provision applies to income years beginning after August 5, 1997.
11. Payments in lieu of dividends that are derived from securities lending transactions pursuant to an agreement in which IRC §1058 applies. This provision also applies to income years beginning after August 5, 1997.

The Tax Reform Act of 1986<sup>12</sup> (TRA86) made a number of significant changes to IRC §954(c), including the addition of gains on the sale of the underlying property

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

that gives rise to dividends, interest, royalties, rents, annuities, hedging transactions, and foreign currency transaction gains. TRA86 also repealed the rules that excluded FPHCI earned by banking, financing, or similar businesses and by insurance companies. However, The Taxpayer Relief Act of 1997 restored in a modified form, the pre-TRA 86 provisions relating to banking, financing, and insurance income. It provides a temporary exemption from FPHCI (for subpart F purposes) and from foreign base company services income certain income derived by a CFC predominantly engaged in the active conduct of an insurance, banking, financing or similar business. The new provisions are applicable for tax years of foreign corporations beginning after December 31, 1997 and before January 1, 1999, and tax years of US shareholders with or within which such tax years of the foreign corporation's tax year ends. The Tax and Trade Relief Extension Act of 1998 extended and modified the temporary exception from subpart F income applicable for taxable years beginning in 1999. See IRC §954(h) and IRC §954(i).

### A. Sale Or Exchange Of Property

To the extent that property gives rise to income that is treated as FPHCI described in IRC §954(c)(1)(A) (dividends, interest, royalties, rents and annuities), gains from the sale or exchange of such property is also considered FPHCI. FPHCI will also include gains from the sale or exchange of an interest in a trust, partnership or REMIC, or non-income producing property.

#### Example 6:

Rich Corporation, a CFC, purchased a Picasso painting as an investment. Prior to selling the painting, Rico temporarily leases the painting for compensation. Is the rental income FPHCI? When Rich sells the painting, is the gain on the sale FPHCI?

Answer: The rental income does not give rise to the type of active rental income excluded from FPHCI. (Refer to the discussion at Part 2(B), Section 9.3(c), Water's-Edge Manual) Thus, the rental income is FPHCI. The gain from Rich's sale of the Picasso painting is also FPHCI. The gain from the sale of the painting is FPHCI because the painting gave rise to rents not derived from an active rental business.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

If the losses from the sale or exchange of property exceed the gains, the net loss is ignored. The net loss cannot reduce other FPHCI.<sup>13</sup>

### B. Commodity Transactions

The term commodity means tangible personal property of a kind which is actively traded or with respect to which contractual interests are actively traded, and nonfunctional currency is defined by IRC §988.<sup>14</sup> The term commodity transactions include the purchase or sale of a commodity for immediate (spot) delivery, or deferred (forward) delivery, or the right to purchase, sell, receive, or transfer a commodity, or any other right or obligation with respect to a commodity, accomplished through a cash or off-exchange market, an interbank market, an organized exchange or board of trade, an over-the-counter market, or in a transaction effected between private parties outside of any market.<sup>15</sup>

If commodity transaction losses exceed the gains, then the net loss is not included as FPHCI and cannot reduce other FPHCI.<sup>16</sup>

Example 7:

Rico, Ltd., a CFC, trades primarily in precious metals. Rico takes delivery of the metals through Bank, as its agent. Rico's business is essentially financial. Is the income derived from these trades FPHCI?

Answer: Yes. Rico is not an active producer, processor, merchant or handler of precious metals. Thus, the gain from the trades does not meet the "regular dealer" in property exception and the income is FPHCI. (Refer to discussion at Part 2C of Section 9.3(c), Water's-Edge Manual)

### C. Foreign Currency Transactions

Foreign currency transactions are defined by IRC §988(b). If the losses of the foreign currency transactions exceed the gains, then the net loss is not FPHCI. Nor can the loss reduce other FPHCI.<sup>17</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### D. Income Equivalent To Interest

For purposes of FPHCI, income equivalent to interest includes amounts that are treated as ordinary income, original issue discount and interest income pursuant to IRC §482, §483, §864(d), §1273, §1274, §1276, §1281, §1286, §1288 and §7872.<sup>18</sup> Income equivalent to interest is included in FPHCI to prevent taxpayers from sheltering passive interest income by changing the form of the foreign passive investment to generate income that is not traditional interest income. Generally, income equivalent to interest would include amounts in which the net income or gain from the CFC's transactions is, in part, based on the time value of money.

Income equivalent to interest includes "factoring" income. Factoring income is the gain derived from the acquisition or disposition of a factored receivable.<sup>19</sup> A factored receivable is an account receivable that is sold to another entity to acquire the cash sooner than if the corporation waits for the customer to actually make payment.

Related party factoring income as defined by IRC §864(d)(1) or (6) is not subject to the income equivalent to interest tests.<sup>20</sup> IRC §864(d)(1) classifies related party factoring income as interest income. IRC §864(d)(6) classifies any income derived by a CFC from a trade or service receivable acquired from a related party as interest income for purposes of FPHCI.<sup>21</sup> Thus, this related party factoring income qualifies as FPHCI without applying the income equivalent to interest rule.

Income that is derived from factoring transactions with unrelated parties is included in FPHCI only if the income is equivalent to interest. Tax-exempt interest income is only included for purposes of the alternative minimum tax.<sup>22</sup>

#### Example 8:

Pete Co., a United States corporation engaged in an integrated credit card business, owns all the stock of Maria S.A., a CFC. On day 1, a customer uses a credit card issued by Pete to purchase merchandise priced at \$250 from an unrelated department store. The receivable bears interest after 30 days. On day 7, the department store transfers the receivable arising from the customer's purchase to Maria in exchange for \$240. Maria collects \$250 from the customer on day 45. Is the income derived by Maria FPHCI?

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

Answer: Yes. The income earned by Maria on the receivable is income equivalent to interest and is FPHCI.

Example 9:

Zot, Inc., a CFC, purchases gold for \$1,000. On the same day, Zot executes a forward contract to sell the gold in 30 days for \$1,100. The \$100 is based on a rate tied to the current interest rates. Is Zot's income FPHCI?

Answer: Yes. Although this income of \$100 does not meet the legal definition of interest, it is considered to be income equivalent to interest because it is driven by current interest rates. It is FPHCI.

Example 10:

Rhino Ltd., a CFC, purchases a commodity on the spot market for \$56,000 and concurrently sells that commodity forward for delivery in three months for a price of \$61,000, the market price for that commodity in the market place. Is this income FPHCI?

Answer: Yes. The \$5,000 gain is considered income equivalent to interest because the gain reflects interest for the three month period. Thus, the entire transaction will be treated as income equivalent to interest and is FPHCI.

## ***2. Fphci Exceptions***

For purposes of FPHCI, the above types of income are included as FPHCI unless the income specifically satisfies one of the following exceptions.

### **A. Dividend And Interest Income**

Dividend and interest income received from an unrelated party are generally always includable as FPHCI. However, interest income is not included if the CFC is engaged in a banking business and the interest is export financing interest.<sup>23</sup> Export financing interest is any interest derived from financing the sale

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

(or other disposition) for use or consumption outside the United States of any property:

1. Which is manufactured, produced, grown or extracted in the United States by the taxpayer or a related person; and
2. Not more than 50 percent of the fair market value of which is attributable to products imported into the United States.

FPHCI will not include dividend and interest income (including factoring income) received from a related party if the related party is organized in the same country as that of the CFC and has substantial assets used in its business in the same country of the CFC. Thus, both related CFCs must be operating and organized within the same country.<sup>24</sup> Related party is defined by a more than 50 percent ownership relationship. Substantial assets are defined as more than 50 percent of the average value of the CFC's total average assets.<sup>25</sup> The regulations provide guidance for determining the location of assets and whether the assets are used in the business.

The exception for interest income will not apply if the interest paid by the payor is deducted and thus reduces its own subpart F income.<sup>26</sup> Dividends are excludible only to the extent paid out of earnings and profits which accumulated during a period when the same country incorporation test and the asset location test were met.<sup>27</sup>

The Taxpayer Reform Act of 1997 provides that if a CFC sells the stock of a foreign subsidiary, IRC §1248 may apply to recharacterize a portion of the gain as a deemed dividend. However, the same country exception under IRC §954(c)(3)(A)(i) will not to apply to deemed §1248 dividends (IRC§964(e)).

Example 11:

Wash Ltd., a CFC, receives interest income from Soap R Us, its United States parent. Wash then pays the same amount of interest to Dry Ltd. Both Wash and Dry are located in Belgium. Is the income FPHCI?

Answer: The interest income received by Wash from Soap R Us is FPHCI. However, there are no earnings and profits because the interest income is offset by the interest expense paid to Dry. Dry's interest income from Wash must be

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

considered FPHCI, because Wash used the interest payment to reduce its own FPHCI.

### B. Rents And Royalties

FPHCI does not include rent and royalty income:

1. Received from a unrelated party, if the CFC derives the rental or royalty income in the active conduct of its trade or business;<sup>28</sup> or if
2. Received from a related party, and if the income producing property is used in the same country as the CFC.<sup>29</sup>

Exception 2 for related party rents and royalties will not apply if the rent or royalty paid by the payor is deducted and thus reduces its own subpart F income.<sup>30</sup> Related party is defined by a more than 50 percent ownership relationship. If the property is used inside and outside the CFC's country of incorporation, then the portion attributable to the non-CFC country is FPHCI.

Example 12:

Bronze Corporation is a CFC operating in Brazil. Steel Corporation, a related party, operates in the United Kingdom, manufacturing widgets. Bronze rents a building located in Brazil (which it uses as its sales headquarters) from Steel and deducts the payments as a rental expense. Bronze has income (foreign base company sales) reportable as subpart F income. The rental expense reduces the gross income that gives rise to subpart F income. Does Steel have rental income qualifying as FPHCI?

Answer: Yes. The rental income does not meet either exception. Steel's active business is not renting buildings and the property is not located in the same country as Steel, in the United Kingdom. Thus, the rental income is FPHCI to Steel.

Example 13:

Lama S.A., a Panamanian CFC, operates a chain of grocery stores and owns a fleet of buses. Iguana S.A., a Mexican CFC, leases the buses from Lama and



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

operates a bus service in Panama City. Is the rental income Lama receives FPHCI?

Answer: No. The rental income meets an exception. Lama's active business is not leasing buses. However, the buses are being used in the same country where Lama is incorporated, in Panama. Thus, the rental income is not FPHCI to Lama.

Example 14:

Lama S.A., a Panamanian CFC, operates a chain of grocery stores and owns a fleet of buses. Iguana S.A., a Mexican CFC, leases the buses from Lama and operates a bus service in Panama City and Colombia. Is the rental income Lama receives FPHCI?

Answer: Yes, but only a portion. A portion of the rental income meets an exception. Lama's active business is not leasing buses. However, since the buses spend half of their time operating in Panama and half in Colombia, 50 percent of the rental income relates to buses operating in the same country where Lama is incorporated, in Panama, and meets the exception. The other 50 percent of the rental income does not meet the exception and is FPHCI to Lama.

Example 15:

Assume the same facts as in Example 12, except the building is located in London. Does Steel have rental income qualifying as FPHCI?

Answer: Yes. The property is located in the same country as Steel, the United Kingdom, so one of the exceptions is met. However, Bronze is reducing its reported subpart F income (foreign base company sales) by the rental expense. This is the exception to the exception. As a result, the same country exception will not apply to Steel and the rental income is FPHCI to Steel.

### C. Gains

The gains from property described in Part 1A of Section 9.3(c), Water's-Edge Manual, whether received from a related or unrelated party, are includable as FPHCI. However, for gains on the sales of property, there is an exception for

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

any regular dealer in property. Gains and losses from the sale or exchange of any such property, or arising out of bona fide hedging transactions reasonably necessary to the conduct of the business of being a dealer in such property, is not FPHCI.<sup>31</sup> Gains and losses from the sale or exchange of property, which is IRC §1221(1) inventory property in the hands of the CFC, is not FPHCI.<sup>32</sup> The Taxpayer Relief Act of 1997 modified the above exception. For tax years beginning after August 5, 1997, the gains on the sales of property exception is expanded to apply not only to any regular dealer in property but also dealers in forward contracts, options, notional principal contracts, or similar financial instruments (including instruments referenced to commodities). (IRC §954(c)(2)(C).)

Example 16:

You-Who, Inc., a CFC, is in the business of buying fine art from unrelated persons, and selling the art to the public. You-Who sells a Picasso for \$1,000,000. Is the gain from the painting FPHCI?

Answer: No. Because You-Who is considered to be an art dealer, the gain meets the exception and is not FPHCI.

There are two additional exceptions for gains from the sale of commodities: qualified active commodity sales and qualified hedging transactions. A qualified active commodity sale is the sale of commodities by a producer, processor, merchant or handler of a commodity in the normal conduct of business, if substantially all of the CFC's business is an active producer, etc., of like kind commodities.<sup>33</sup> A qualified hedging transaction is a bona fide hedging transaction that:

1. Is reasonably necessary to the conduct of business as a producer, processor, merchant or handler of a commodity in the manner in which such business is customarily and usually conducted by others;
2. Is entered into primarily to reduce the risk of price change (but not the risk of currency fluctuations); and
3. Is clearly identified on the CFC's records before the close of the fifth business day after the day the contract is entered into and there is a reasonable risk of loss at the time.

Example 17:

**The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated**

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

Zoe Corporation, a CFC, purchases grain that it refines, mixes, crushes, aerates and mills prior to sale. Zoe incurs substantial expenses performing these activities in the ordinary course of its commodity business. Is Zoe's income from the grain sales FPHCI?

Answer: No. Because Zoe is actively engaged in the commodity business, the income meets the exception and is not FPHCI.

Foreign currency gains and losses are excluded from FPHCI if they arise from a qualified business transaction or a qualified hedging transaction and are clearly identified on the records of the CFC.<sup>34</sup> A qualified business transaction is a transaction that does not have investment or speculation as a significant purpose; is not attributable to property or an activity that gives rise to or may reasonably be expected to give rise to subpart F income; and is attributable to certain business transactions as defined in the regulations.<sup>35</sup>

To be excluded from FPHCI, the transaction must clearly be identified on the CFC's books and records. Also, if the CFC becomes the obligor under a debt instrument, then the CFC must identify the debt and the expenses related to the debt within five days of the date on which the expenses are incurred.

In general, a qualified hedging transaction must be reasonably necessary to the conduct of regular business operations, entered into primarily to reduce the risk of currency fluctuations with respect to qualified business transactions; the property or expense to which the hedge relates must be clearly identified on the CFC's books and records; and the amount of foreign currency gain or loss attributable to the specific hedging transaction must be clearly identified on the CFC's books and records.<sup>36</sup>

If you think you have a potential adjustment for FPHCI, you should read the federal regulations. The federal regulations contain many definitions, special rules and exceptions not covered in great detail in this discussion.

### ***3. Passive Foreign Investment Companies***

The TRA86 introduced the concept of a Passive Foreign Investment Company (PFIC). Chapter 10, Water's-Edge Manual discusses the PFIC provisions and the

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

effect to the California return. There is a passive income test and a passive asset test to determine whether a foreign corporation qualifies as a PFIC. For purposes of these tests, passive income is defined by reference to IRC §954(c). As a result, FPHCI could be taxed by both the subpart F provisions and the PFIC provisions. However, IRC §951(f) provides when both the subpart F provisions and the PFIC provisions can subject the FPHCI to tax, the subpart F provisions do take precedence.

Thus, realize that there is an overlap between these tax provisions. When the two overlap, apply the subpart F rules to the passive income. Refer to Chapter 10, Water's-Edge Manual for more information about PFICs.

### ***4. Multi-Tiered CFCs And IRC §959(b)***

For federal purposes, when a lower-tier CFC earns income that is treated as subpart F income, the income is taxed as a "subpart F" deemed dividend to the United States shareholder. If the earnings are subsequently distributed to a higher-tier CFC, the dividend would qualify as FPHCI to the higher-tier CFC, but the dividend income of the higher tier CFC would not be included as subpart F income to the US shareholder. In general, dividend income qualifies as FPHCI to the higher tier CFC when received and is included as subpart F income to the US shareholder, but if the dividend was paid out of previously taxed earnings and profits, the dividend will not be included as subpart F income to the US shareholder for federal purposes.

The dividend paid by a lower-tier CFC to a higher-tier CFC is not considered an "intercompany dividend" for federal tax purposes because CFCs are not included in the consolidated federal return. However, when a dividend is distributed from one CFC to another CFC, IRC §959(b) excludes those dividends from the recipient CFC's gross income to the extent that they are paid out of E&P that was previously taxed to the United States shareholder as a Subpart F deemed dividend.

Thus, the federal rules allow a look through the CFC tiers to determine whether or not the dividend was paid from income previously taxed pursuant to subpart F of the IRC. If the dividend income has previously been included in the taxable income of the United States shareholder, IRC §959(b) specifically provides that the dividend is not included again as a deemed dividend pursuant to IRC §951.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### Example 18:

Calc USA owns 100 percent of Calc AG, a Swiss CFC, which owns 100 percent of Calc GmbH, a German CFC. During 1994, Calc GmbH earns \$125,000, of which \$86,000 qualifies as subpart F income. During 1994, Calc AG has no income or investments other than the income that is derived from a distribution of \$80,000 from Calc GmbH. Calc AG has earnings and profits of \$80,000 in 1994. For federal purposes, what must Calc USA report?

Answer: For federal purposes, in 1994 Calc USA is required to include \$86,000 as a subpart F deemed dividend (Calc GmbH's subpart F income). The \$80,000 distribution received by Calc AG from Calc GmbH would constitute subpart F income for Calc AG. However, by reason of IRC §959(b) and Treasury Regulation §1.959-2(a), the \$80,000 does not constitute gross income for Calc AG for purposes of determining amounts includable in Calc USA's gross income pursuant to IRC §951(a)(1)(A)(i).<sup>37</sup>

For California purposes, the tax treatment of this distribution differs substantially from the federal treatment. Since California does not tax subpart F income, the dividend paid by the lower tier CFC can never be considered paid out of previously taxed E & P for California purposes. Therefore this dividend income will generally qualify as subpart F income for inclusion ratio purposes.

For federal purposes, a dividend paid out of previously taxed E & P is not considered income to the higher tier CFC and may not show up as income on the 5471 of the higher tier CFC. The net income subject to the inclusion ratio should include this dividend income.

The denominator of the inclusion ratio (current E & P), should include this dividend income. For federal purposes, the current E & P calculated under §964 will include the previously taxed dividend. Under Revenue Ruling 86-33, dividends paid out of previously taxed E & P are included in the earnings and profits of the higher tier CFC. If the dividend income was included in the higher tier CFC's E & P as required for federal purposes, then an adjustment will not be necessary to the denominator of the inclusion ratio.

If the lower-tier CFC has income that qualifies as subpart F income, then the CFC is included in the water's-edge combined report based on its inclusion ratio.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

If the higher-tier CFC receives a dividend from the lower-tier CFC, then the same subpart F income analysis is needed to determine whether or not the higher-tier CFC has subpart F income. Because dividends generally qualify as FPHCI, the higher-tier CFC will typically have subpart F income, and will be included in the water's-edge combined report based on its inclusion ratio.

Thus, both CFCs may be included. However, if this occurs and both CFCs are included in the water's-edge combined report, then a determination must be made as to what extent any actual distributed dividend qualifies for elimination pursuant to Revenue and Taxation Code (RTC) §25106. (Elimination of a dividend pursuant to RTC §25106 does not effect its treatment as subpart F income. The subpart F rules are applied on a separate company by company basis.) Refer to CCR §24411(i)(4) for examples of the application of RTC §25106 to CFCs. Also, for more information on the foreign dividend deduction refer to Chapter 13, Water's-Edge Manual.

### Example 19:

Calc USA owns 100 percent of Calc AG, a Swiss CFC holding company. Calc AG owns 100 percent of Type Ltd., an Ireland corporation primarily engaged in manufacturing. The lower-tier CFC, Type, pays a dividend of \$5 million to the higher-tier CFC, Calc AG. Type has subpart F income of \$10 million and current E & P of \$100 which results in a 10 percent inclusion ratio. The high-tier CFC, Calc AG, pays a dividend of \$10 million to Calc USA. Calc AG has subpart F income of \$20 million from interest income it received during the year and it has current E & P of \$100 million. Calc USA, Calc AG and Type have always filed on a unitary combined basis. What happens as a result of both Calc AG and Type having subpart F income and both distributing income?

### Discussion and Answer:

For federal purposes:

Type has subpart F income of \$10 million, which is a deemed dividend to Calc USA. Calc AG has subpart F income of \$25 million. However, of this \$25 million, \$5 million is from a dividend paid by Type which is considered previously taxed income under IRC §959(b). Thus, the \$5 million dividend has already been included in the United States shareholder's income as a deemed dividend pursuant to IRC §951. As a result, pursuant to IRC §959(b), Calc USA only has

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

to report \$20 million as subpart F income. Calc USA received a dividend of \$10 million from Calc AG. Because this dividend is considered paid out of previously taxed E & P, the dividend is not included in Calc USA's income pursuant to IRC §959(a).

For California purposes:

Based on the ratio of subpart F income over the current year earnings and profits, Type is included in the water's-edge combined report 10 percent ( $\$10,000,000/\$100,000,000$ ) and Calc AG is included 25 percent ( $\$25,000,000/\$100,000,000$ ). Calc AG's subpart F income for inclusion ratio purposes includes the \$5 million dividend paid by Type even though the \$5 million is not treated as subpart F income for federal purposes. Remember that for California purposes, the dividend paid by Type is not considered paid out of previously taxed E & P. Of the \$5 million dividend Calc AG received, \$1,250,000 ( $\$5,000,000 \times 25\%$ ) is included in the water's-edge combined report. Because both Type and Calc AG are partially included CFCs, a portion of the \$1,250,000 dividend will be eliminated under RTC §25106. Of the \$1,250,000 dividend included in the combined report by Calc AG, \$125,000 of the dividend is intercompany eliminated under RTC §25106 (assuming the dividend was paid out of current E & P). The intercompany portion was calculated by multiplying the \$1,250,000  $\times$  10% which is Type's inclusion ratio. The balance of the dividend ( $\$1,250,000 - 125,000 = \$1,125,000$ ) is a qualifying dividend which will qualify for the RTC §24411 deduction.

Of the \$10 million dividend Calc USA received from Calc AG, \$2,500,000 ( $\$10,000,000 \times 25\%$ ) is intercompany eliminated pursuant to RTC §25106 because Calc AG is 25 percent included in the water's-edge combined report. The remaining 75 percent of the dividend remains in the water's-edge combined report and will qualify for the foreign dividend deduction pursuant to RTC §24411. The elimination of an intercompany dividend or the fact that a dividend qualifies for the foreign dividend deduction does not change the CFCs inclusion rates of 10 percent and 25 percent.

If the higher tier CFC's only source of income is the dividend it receives from a lower tier CFC, then there may be little if any tax effect of including the higher tier CFC in the combined report since the dividend will either be eliminated under RTC §25106 or deducted under RTC §24411.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

Note that in Example 19 Calc AG is a holding company yet only 25 percent of its income is subpart F income. If a CFC is truly a holding company, then its income should be passive in nature and should qualify as FPHCI. If an auditor finds this to be the case, the auditor should question why the passive income is not FPHCI. The taxpayer may be applying federal rules to which California has not conformed to eliminate the FPHCI from subpart F income.

Refer to [Exhibit 9.3B](#), which contains a summary of FPHCI.



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **d. Foreign Base Company Sales Income**

#### **1. In General**

Foreign base company sales income (FBCSales) consists of gross income (e.g., profits, commissions, fees) derived from any one of the following types of transactions:

1. Personal property purchased by the CFC from a related person and sold to an unrelated person;
2. Personal property purchased by the CFC from an unrelated person and sold to a related person;
3. Personal property purchased from any person by the CFC on behalf of a related person; or
4. Sale of any personal property to any person by the CFC on behalf of a related person.<sup>38</sup>

Items #1 and #2 above relate to direct sales, while items #3 and #4 above relate to a broker or sales office transactions. For income to be considered FBCSales, it must be derived from one of the above four transactions. A related person is defined as an over 50 percent ownership relationship.<sup>39</sup> In addition, the transaction must meet the following two conditions. Note that both of these requirements must be met:

- A. The personal property purchased or sold must be manufactured, produced, grown or extracted outside the country of incorporation of the CFC;<sup>40</sup> and
- B. The personal property is purchased or sold for use, consumption or disposition outside of the CFC's country of incorporation.<sup>41</sup>

Refer to [Exhibit 9.3C](#), which contains a diagram summarizing FBCSales.

Personal property does not include the sale of agricultural commodities which are grown outside of the United States in commercially marketable quantities. Treasury Regulation §1.954-3(a)(1)(ii) specifically identifies bananas, black pepper, cocoa, coconut, coffee, crude rubber and tea as commodities that would qualify for this exception. The regulation also provides a table describing commodities that are considered grown in the United States and that do not meet this exception. The table lists approximately 20 types of livestock and products,

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

and 80 different crops. Further, the regulation specifically excludes timber from the definition of an agricultural commodity that qualifies for the exception.

A special rule exists for certain timber products. FBCSales includes any income derived in connection with the sale of unprocessed timber, defined in IRC §865(b), and the milling of such timber outside the United States. Any amount that would be included here as FBCSales is excluded from subpart G of the IRC dealing with export trade companies.<sup>42</sup>

### Example 20:

Wolfgang Corporation, a CFC organized under the laws of Switzerland, is wholly owned by Mike Company, a United States corporation. Wolfgang purchases articles manufactured by Mike in the United States and sells them to Giuseppe Corporation, an unrelated party, for use in Italy. Is the gross income from Wolfgang's sales FBCSales?

Answer: Yes. The transactions meet the type described in item #1 above. In addition, the transactions meet both item A and B above. Thus, the gross income Wolfgang derived from the transactions is FBCSales.

### Example 21:

Assume the same facts as in Example 20, except in addition Wolfgang purchases from Giuseppe articles manufactured in Italy and sells them to Pepe Company, a related corporation, for use in France. Is the gross income from Wolfgang's sales FBCSales?

Answer: Yes. The transactions meet the type described in item #2 above. In addition, the transactions meet both item A and B above. Thus, the gross income Wolfgang derived from the transactions is FBCSales.

### Example 22:

Soho, Ltd., a CFC incorporated in Singapore, is a wholly owned subsidiary of Sing, Inc., incorporated in Taiwan. Soho purchases and imports into Singapore rough diamonds mined in Brazil. In Singapore Soho cuts, polishes and shapes the diamonds in a process considered to be manufacturing. Soho sells the

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

finished diamonds to Sing, which in turn sells the diamonds to unrelated parties for use in Japan. Is the gross income from the sale of diamonds FBCSales to Sing?

Answer: Yes. The transactions meet the type describes in item #1 above. In addition, the transactions meet both item A and B above. Thus, the gross income Sing derived from the transactions is FBCSales.

If assembled goods are sold to unrelated parties for use, consumption or disposition outside the country of the CFC's incorporation, only part of the income on the sale may be FBCSales income.<sup>43</sup> This is true if one of the following applies:

1. The CFC purchases some of the components from related persons and others from unrelated persons; or
2. Some of the components are produced in the CFC's country of incorporation, and others are not.

Example 23:

Zot, Inc., is a CFC incorporated in Hong Kong. How much FBC Sales does Zot have? Zot has the following purchases and sales:

Cost of Purchased Components:	
Manufactured within HongKong	\$20
Manufactured without HongKong	<u>40</u>
Total	<u>60</u>
Cost of Components made outside of HongKong	
Purchased from Unrelated Persons	\$10
Purchased from Related Persons	<u>30</u>
Total	<u>\$40</u>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

Zot has the following income:

Gross Income From Sales	
Gross Receipts	\$120
Cost of Goods Sold:	
Component \$60	
Labor and Overhead \$10	<u>70</u>
Gross Income	<u>\$50</u>
Net Income from sales:	
For Use in Hong Kong	\$26
For Use outside of Hong Kong	<u>24</u>
Total	<u>\$50</u>

Answer: Zot has FBCSales. This is determined by multiplying the net income related to goods used outside of Hong Kong by the ratio of the cost of purchases manufactured outside of Hong Kong and purchased from related parties to the total cost of the components. Thus, Zot's FBCSales are \$12 ( $\$24 \times \$30/\$60$ ).

## 2. Fbcsales Same Country Exceptions

### A. Manufacture Of Goods Within The Same Country

FBCSales does not include the income derived in connection with property that is manufactured, produced, constructed, grown or extracted within the same country in which the CFC was created or organized.<sup>44</sup> It is not relevant whether the goods are sold to a related or unrelated party.

Example 24:

Soho, Ltd., a CFC incorporated in Singapore, is a wholly owned subsidiary of Sing, Inc., also incorporated in Singapore. Soho purchases and imports into Singapore rough diamonds mined in Brazil. In Singapore Soho cuts, polishes and shapes the diamonds in a process considered to be manufacturing. Soho

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

sells the finished diamonds to Sing, which in turn sells the diamonds for use in Japan. Is the gross income from the sale of diamonds FBCSales to Sing?

Answer: No. Because the finished diamonds were prepared (manufactured) in Singapore, the same country in which Sing is organized, the gross income derived by Sing is not FBCSales.

Example 25:

Swisso Co., a Swiss CFC, purchases goods manufactured in Switzerland and sells the goods to Chia, Ltd., a related CFC in Hong Kong. Is the gross income from the sale of these goods FBCSales to Swisso?

Answer: No. Because the goods are manufactured within Switzerland, the country of Swisso's incorporation, the sales are not FBCSales. The fact that Chia is related is irrelevant.

### B. Consumption Of Goods Within The Same Country

FBCSales does not include the income derived in connection with property that is sold for use, consumption or disposition within the same country in which the CFC was created or organized.<sup>45</sup>

Example 26:

Soho, Ltd., a CFC incorporated in Singapore, is a wholly owned subsidiary of Sing, Inc., incorporated in Taiwan. Soho purchases and imports into Singapore rough diamonds mined in Brazil. In Singapore Soho cuts, polishes and shapes the diamonds in a process considered to be manufacturing. Soho sells the finished diamonds to Sing, which in turn sells the diamonds to unrelated parties for use in Taiwan. Is the gross income from the sale of diamonds FBCSales to Sing?

Answer: No. Because the finished diamonds are sold for use and consumption in Taiwan, the same country in which the Sing was organized, the gross income derived by Sing is not FBCSales. Whether Sing sells to related or unrelated parties is not relevant.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### 3. *Fbcsales Manufacturing Exception*

FBC Sales does not include income derived in connection with the purchase and sale of personal property if the personal property has been manufactured, produced, constructed, grown or extracted by the CFC. Note this includes any CFC manufacturing personal property, regardless of in which country it is manufactured or consumed.<sup>46</sup>

A major issue to consider when a CFC is involved in the purchase or sale of personal property is whether the property was manufactured by the CFC, especially if the property or a component of the property was purchased by the CFC and then resold. This determination constitutes the bulk of the audit work related to FBC Sales. The statutory language of IRC §954(d)(1), which discusses manufacturing, is identical to the language used in IRC §927(a)(1), related to FSCs, and IRC §993(c)(1), related to DISCs.

The regulations make it clear that in no event will packaging, repackaging, labeling or minor assembly constitute the manufacture or production of property.

Example 27:

Soho, Ltd., a CFC incorporated in Singapore, is a wholly owned subsidiary of Sing, Inc., incorporated in Taiwan. Soho purchases and imports into Singapore rough diamonds mined in Brazil. In Singapore Soho cuts, polishes and shapes the diamonds in a process considered to be manufacturing. Soho sells the finished diamonds to Sing, which in turn sells the diamonds to unrelated parties for use in Japan. Is the gross income from the sale of diamonds FBCSales to Sing? Is the gross income from the sale of diamonds FBCSales to Soho?

Answer: For Sing, the answer is yes. As discussed in Example 22, these sales are FBCSales to Sing. However for Soho, the answer is no. Because the finished diamonds are prepared (manufactured) by Soho, the gross income derived by Soho is not FBCSales because the sales meet the manufacturing exception.<sup>47</sup>

Treasury Regulation §1.954-3(a)(4) provides guidelines and examples to determine whether a CFC manufactured or produced the personal property in question. There are two separate tests applied, a substantial transformation test

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

and a substantial operations test. If either of these tests is met, then the CFC is manufacturing or producing the goods.

### A. Substantial Transformation Test

The purchased property is treated as manufactured, produced or constructed by the selling corporation if it was "substantially transformed" prior to the sale. Regulations on substantial transformation have never been issued. However, examples of substantial transformation include the transformation of:

1. Wood pulp to paper;
2. Steel rods to nuts and bolts; and
3. Fresh fish to canned fish.<sup>48</sup>

Thus, the raw material or component must be transformed into an end product that is a separate, visibly different product. Substantial transformation occurs when, as a result of a manufacturing process, a new and different article emerges, having a distinctive name, character or use, which is different from that originally possessed by the article or material before being subject to the manufacturing process.

A recent court decision provided a liberal interpretation of what constitutes substantial transformation for purposes of the manufacturing exception to FBCSales income. In Bausch & Lomb, Inc. v. Commissioner,<sup>49</sup> a Hong Kong and Ireland CFC purchased components for sunglasses, including lenses, frames, screws, and packaging materials, primarily from the parent. The CFCs then assembled those components into sunglasses and sold the assembled sunglasses outside the CFC's country of incorporation. The court held that the CFCs sunglass assembly operations, even though they did not rise to the level of full-fledged manufacturing, were sufficient to avoid the FBCSales rules of subpart F. However, use of the facts and circumstances test to qualify for the manufacturing exception will require the taxpayer to furnish evidence demonstrating that the activities in question are substantial, and are considered manufacturing within that particular industry.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

### B. Substantial Operations Test

When the purchased property is a component part of a product to be sold, the use of the part may be considered to constitute the manufacture of a product under this test, even though a substantial transformation does not take place. The CFC meets this test if the CFC's conversion costs (direct labor and factory overhead) incurred in connection with the product are 20 percent or more of the total cost of goods sold.

Example 28:

Ash GmbH, a German CFC, sells industrial engines outside of its country of incorporation, in Belgium. Ash purchases component parts from both related and unrelated persons in other countries. On a per unit basis, Ash's selling price and costs are as follows:

<b><u>ASH</u></b>		
Selling Price		\$400
Cost of Goods Sold:		
Raw Materials:		
Acquired from related parties	\$100	
Acquired from Unrelated parties	40	
Total Raw Materials	<u>\$140</u>	
Conversion Costs:		
Labor	\$50	
Overhead Allocation	<u>\$20</u>	
Cost of Goods Sold		<u>210</u>
Gross Profit		190
Selling, General & Administrative Expenses		<u>50</u>
Net Income Before Tax		<u>\$140</u>

Because the conversion costs of \$70 (\$50 + \$20) are more than 20 percent of the total cost of goods sold (\$70/\$210 = 33%), Ash is considered to have

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

manufactured the product it sells.<sup>50</sup> As a result, the taxable income of \$140 is not considered to be FBCSales.

Note however, the substantial operations test is not necessarily a bright line test. Even though the conversion costs may be less than 20% of the total cost of goods sold, the transaction may still constitute manufacturing if the conversion process is substantial and generally considered to constitute the manufacture, production or construction of property. This is a facts and circumstances determination. On the other hand, packaging, repackaging, labeling or minor assembly operations will never constitute manufacturing for purposes of this provision.

### Example 29:

Birch Company, a CFC, purchases from related persons radio parts manufactured in other countries. Birch designs radio kits, packages the component parts required for assembly of the kits and sells the kits to unrelated persons in other countries. The packaging operations of Birch do not constitute the manufacture, production or construction of personal property.<sup>51</sup> Birch must report the gross income from the sale of the kits as FBCSales.

### Example 30:

Speedy Ltd., a CFC, operates an automobile assembly plant in Switzerland. Speedy purchases assembled engines, transmissions and other parts from a related French CFC. Speedy also purchases additional components from unrelated parties. Speedy conducts stamping, machining, subassembly operations and has a substantial investment in the machinery it uses in the assembly plant. Is Speedy manufacturing its product? On a per unit basis, Speedy's selling price and costs are as follows:

<b><u>SPEEDLY LTD.</u></b>		
Selling Price		\$2,500
Cost of Goods Sold:		
Raw Materials:		
Acquired from related parties	\$1,200	
Acquired from Unrelated parties	<u>275</u>	
Total Raw Materials	<u>\$1,475</u>	

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

Conversion Costs:		
Labor	\$275	
Overhead Allocation	<u>\$50</u>	
Cost of Goods Sold		<u>1,800</u>
Gross Profit		700
Selling, General & Administrative Expenses		<u>300</u>
Net Income Before Tax		<u>\$400</u>

Discussion and Answer: The conversion costs of \$325 (\$275 + \$50) are less than 20 percent of the total cost of goods sold ( $\$325/\$1,800 = 18\%$ ), therefore Speedy does not meet the 20 percent threshold.

However, Treasury Regulation §1.954-3(a)(4)(iii)(Example 2) indicates that the operations conducted by Speedy are substantial in nature and are generally considered to constitute the manufacture of a product. The facts and circumstances that would support that Speedy's operations are "substantial in nature" and considered to constitute the manufacture of a product are perhaps that:

1. Conversion costs are close to 20 percent of the total cost of goods sold;
2. Speedy has a substantial investment in the assembly plant; and
3. The operation appears to be a major operation, more than minor assembly.

(Note that in this example, the regulation points out that the substantial transformation test was not met because the automobile is not sufficiently distinguishable from the components. The parts still exist; they were not transformed into an automobile.)

### ***4. Treatment Of Certain Branch Income***

When a CFC carries on activities through a branch or similar establishment outside the country of the CFC's incorporation, and the activity has substantially the same effect as if such branch were a wholly owned subsidiary, the branch income is treated as income derived by a wholly owned subsidiary of the CFC

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

and can constitute FBCSales of the CFC.<sup>52</sup> This branch rule only applies to FBCSales. A branch can be classified as a sales and purchasing branch or as a manufacturing branch.

### Example 31:

A United States corporation forms a wholly owned subsidiary, O'Golly, Ltd., an Irish CFC, which assembles staplers in Ireland and sells them through sales branches operated in Norway and Sweden. The O'Golly sales branches sell the staplers to the United States parent for use in the United States. O'Golly is considered to be manufacturing in Ireland. Are O'Golly's sales transacted through the Norwegian and Sweden sales branches FBCSales?

Answer: Yes. Because of the branch rule, each branch is treated as a deemed subsidiary and a separate CFC. The income from the Irish manufacturing branch is not FBCSales income because the branch meets the manufacturing exception. However, the income the O'Golly sales branches receive from the sale of staplers is FBCSales.

The branch rule applies to a sales or purchasing branch if the branch's effective tax rate is:

1. Less than 90 percent of the CFC's hypothetical effective tax rate and
2. At least 5 percentage points less than the CFC's hypothetical effective tax rate.<sup>53</sup>

The branch rule applies to a manufacturing branch if the CFC's effective tax rate is:

1. Less than 90 percent of the branch's hypothetical effective tax rate, and
2. At least 5 percentage points less than the branch country's hypothetical effective tax rate.<sup>54</sup>

The rules for determining the hypothetical tax rate are found under Regulation 1.954-3(b)(2)(i)(d). If the CFC has a selling branch, the hypothetical tax is calculated by taking the actual income earned by the selling branch and applying the tax laws of the country in which the CFC is organized in. The hypothetical tax rate is then determined by dividing the hypothetical tax by the income earned by the selling branch.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

If the CFC has a manufacturing branch, the hypothetical tax is calculated by taking the actual income earned by the CFC and applying the tax laws of the country in which the manufacturing branch is located in. The hypothetical tax rate is then determined by dividing the hypothetical tax by the income earned by the CFC.

If the CFC has more than one branch or a mixture of sales and manufacturing branches, then the above rules are applied separately to each branch as if it was the CFC's only branch.<sup>55</sup>

### Example 32:

A CFC manufactures goods in Spain, the country under whose laws it is organized, and sells the goods through a branch in Portugal. The CFC earns a total of \$300 for the year. The branch in Portugal earns \$200 and the CFC generates \$100 from their operations in Spain. If the tax laws of Spain were applied to the income earned by the branch office, the result would be a tax liability of \$100. The income earned by the branch office in Portugal was subject to a \$20 Portuguese tax liability. Do the branch rules apply?

Answer: Yes. The hypothetical tax is \$100. The hypothetical tax rate is calculated by dividing the hypothetical tax by the income earned by the branch office. The result is 50% ( $\$100/\$200$ ). The selling branch's effective tax rate is 10% ( $\$20/\$200$ ). Since the effective tax rate of the selling branch is less than 90% of the hypothetical tax rate ( $90\% \times 50\% = 45\%$ ) and since it is 5 percentage points less than the hypothetical tax rate, the Portuguese branch office will be treated as a separate CFC for purposes of calculating subpart F income.

The branch and CFC are treated separately for purposes of determining foreign base company sales, the de minimis rule, the high foreign tax rule and the full inclusion rule. For all other purposes, the CFC and the branch are not treated as separate corporations.<sup>56</sup> Income can be allocated to FBCSales or non-subpart F income when only a portion of the CFC's or branch's activities qualify as FBCSales.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### 5. Contract Manufacturing

In a typical contract manufacturing arrangement, instead of conducting manufacturing operations itself, a company will hire a provider of manufacturing services to manufacture its products. Prior to 1997, Revenue Ruling 75-7 had set forth criteria under which the activities of a contract manufacturer would be imputed to the CFC that engaged its services. If those criteria were met, a CFC that did not do its own manufacturing could still meet the manufacturing exception if it contracted to have its products manufactured. To the extent that the activities of a contract manufacturer were imputed to the CFC for purposes of the manufacturing exception, Rev. Rul. 75-7 also stated that the contract manufacturer should be treated as a branch of the CFC for purposes of the branch rule. Therefore, if the contract manufacturer were located in a country other than where the CFC had a sales branch, the branch rule could cause the manufacturing and sales branches to be treated as separate deemed subsidiaries, which could cause the sale branch to have FBCSales.

In two 1990 court decisions, the Tax Court found that a contract manufacturer could not be considered a branch of the CFC for purposes of the branch rule (*Ashland Oil Co. v. Commissioner*, 95 T.C. 348 (1990); *Vetco, Inc. v. Commissioner*, 95-TC 579 (1990)). Those decisions did not address whether the contract manufacturer's activities could still be imputed to the CFC for purposes of the manufacturing exception. However, Revenue Ruling 97-48 was issued to revoke Rev. Rul. 75-7 in its entirety effective December 8, 1997. For years beginning prior to that date, Rev. Rul 97-48 would only allow a taxpayer to rely on Rev. Rul 75-7 for purposes of the manufacturing exception if it also applied the branch rule to the contract manufacturing activity.

### 6. Income Allocation Rules

When only a portion of a CFC's or branch's purchases or sales are to a related party, the following allocation rules should be applied.<sup>57</sup> If the CFC or the branch makes purchases from a related party outside the country of the CFC's or branch's incorporation and sells the goods to an unrelated party outside of the country of the CFC's or branch's incorporation, then:

$$\text{NET INCOME FROM} \quad \times \quad \frac{\text{RELATED PURCHASES}}{\text{RELATED PURCHASES}} \quad = \quad \text{FBCSales}$$

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

UNRELATED SALES

TOTAL COSTS

If the CFC or the branch makes purchases from an unrelated party outside the country of the CFC's or branch's incorporation and sells the goods to a related party outside of the country of the CFC's or branch's incorporation, then:

$$\begin{array}{l} \text{NET INCOME FROM} \\ \text{RELATED SALES} \end{array} \quad \times \quad \frac{\text{UNRELATED PURCHASES}}{\text{TOTAL COSTS}} = \text{FBCSales}$$

If the CFC or the branch makes purchases from a related party outside the country of the CFC's or branch's incorporation and sells the goods to a related party outside of the country of the CFC's or branch's incorporation, then:

$$\begin{array}{l} \text{NET INCOME FROM} \\ \text{RELATED SALES} \end{array} \quad \times \quad \frac{\text{RELATED PURCHASES}}{\text{TOTAL COSTS}} = \text{FBCSales}$$

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **e. Foreign Base Company Services Income**

#### **1. In General**

Foreign base company services income (FBCServices) is by far the most common type of FBCI issue raised during an Internal Revenue Service (IRS) examination. This becomes an issue particularly when a United States corporation, engaged in a service industry (e.g., engineering), will operate their most profitable contracts through a CFC located in a tax haven country.

FBCServices is income earned in connection with a CFC's performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or similar services performed outside of the CFC's country of incorporation on behalf of or for a related person. A related person has the same meaning as that used for purposes of determining FBCSales, a more than 50 percent relationship.<sup>58</sup>

The following two conditions must be satisfied for the service income to be considered FBCServices:

1. The services must be performed outside of the CFC's country of incorporation; and
2. The services must be performed for or on behalf of a related person.

For purposes of FBCServices, services are considered to be performed at the physical location of the person(s) providing the services. Treasury Regulation §1.954-4(b)(1) describes what is meant by services performed for or on behalf of a related person and provides specific examples. The following examples demonstrate where services are performed for or on behalf of related party, although such services are not limited to these situations:

1. The CFC is paid or reimbursed by, is released from an obligation to, or otherwise receives substantial financial benefit from a related person for performing services;
2. The CFC performs services (whether or not with respect to property sold by a related person) which a related person is, or has been obligated to perform;

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

- 
3. The CFC performs services with respect to property sold by a related person and the performance of the services are a condition or a material term of the sale; or
  4. Substantial assistance contributing to the performance of the services has been furnished by related persons.<sup>59</sup>

### Example 33:

Pan Ltd., a CFC incorporated in Japan, is paid by a related United States corporation, Mike Company, for the installation and maintenance of industrial machines that Mike manufactures in the United States. Mike sells the machines to unrelated Wong Ltd., located in Hong Kong. Are these FBCServices to Pan?

Answer: Yes. Both conditions are met for these services to be considered FBCServices, the services are performed outside of Japan (where Pan is organized) and the services are performed on behalf of a related person, Mike.

### Example 34:

Norton Unlimited, a United States corporation, is obligated by contract with an unrelated person to construct a ten-lane highway in Argentina. Norton assigns the contract to Carmine Company, a Peruvian CFC. Norton is released from the contract obligation. Is this FBCServices to Carmine?

Answer: Yes. The construction of the highway by Carmine is considered FBCServices. Both conditions are met for these services to be considered FBCServices, the services are performed outside of Peru (where Carmine is organized) and the services are performed on behalf of a related person, Norton.

### Example 35:

Drills, Ltd., a French CFC, enters into a contract with an unrelated Greek company to drill an oil well outside of France. Big Wells Company, a United States corporation, own 100 percent of Drills. Drills employs a relatively small clerical and administrative staff and owns the needed well-drilling equipment. Most of the technical and supervisory personal who oversee the oil well drilling by Drills are regular employees of Big Wells who are temporarily employed by Drills. In addition, Drills hires unskilled and semiskilled laborers to work on the drilling project. Is Drills' service income FBCServices?



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

Answer: Yes. The services performed by Drills are performed for, or on behalf of, a related person (Big Wells) because the services of the technical and supervisory personnel, which are provided by Big Wells, are of substantial assistance in the performance of Drills' contract. The assistance provides Drills with the skills which are a principle element in producing the service income.

Refer to [Exhibit 9.3D](#), which contains a diagram summarizing FBCServices.

### **2. FBCservices Exceptions**

There are three exceptions for FBC Services. If the service income of a CFC meets any of these three exceptions, then the service income is not FBC Services:

1. The service income directly relates to the CFC's sale or exchange of property manufactured, produced, grown or extracted by the CFC, and relates to performance before the time of the sale or exchange of the property;
2. The service income directly relates to an offer or effort to sell or exchange property manufactured, produced, grown or extracted by the CFC;<sup>60</sup> or
3. If the related party's only role is to guarantee performance.<sup>61</sup>

In situations #1 and #2 above, the service income would be analyzed under the rules applicable to FBCSales to determine whether or not the income is subpart F income as opposed to being evaluated under the FBC Services rules. For item #3 above, the service income is excluded if all of these conditions are met:

1. If the related person's sole obligation with respect to a service contract is to guarantee performance;
2. The CFC is fully obligated to perform the services required of the contract;
3. Any related person does not pay for performance of, or perform, any of the services which are guaranteed; and
4. Any related person does not pay for performance of, or perform, any significant services related to such services.<sup>62</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### Example 36:

Asphalt, Inc., a United States corporation, contracts to construct a four-lane highway in a foreign country. Asphalt immediately assigns the entire contract to its wholly owned foreign subsidiary, Bumpy Ltd. The other (unrelated) party to the contract does not release Asphalt of its obligation under the contract; the sole purpose of the arrangement is to have Asphalt guarantee performance of the contract by Bumpy.

Bumpy is capable of performing the construction contract. Neither Asphalt nor any other person related to Bumpy at any time performs or pays for any significant services needed for the construction contract. Is Bumpy, the CFC, deemed to be performing services for or on behalf of Asphalt?

Answer: No. Bumpy is capable of performing the services. And since Asphalt's only role is to guarantee Bumpy's performance, then the performance by Bumpy is not considered to be on behalf of Asphalt. The service income is not FBCTServices.

### **3. Substantial Assistance Issue**

The most common form of FBCTServices is service income derived from the CFC's contract while receiving substantial assistance (e.g., technical, financial, managerial, supplying equipment, etc.,) from the parent corporation or other related person. To raise the issue of FBCTServices successfully, the auditor will need to know what type of services constitute substantial assistance. A working knowledge of the rules pursuant to the federal regulations is essential.

Treasury Regulation §1.954-4(b)(1)(iv) provides, "...services which are performed for, or on behalf of, a related person include...services performed by a CFC in a case where substantial assistance contributing to the performance of such services has been furnished by a related person." Treasury Regulation §1.954-4(b)(2)(ii)(a) provides, "...'substantial assistance' furnished by a related person to a CFC includes...direction, supervision, services, know-how...etc."

One of the most significant questions to address is what is "substantial" assistance? Treasury Regulation §1.954-4(b)(2)(ii)(b) provides a two-pronged

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

test to determine whether or not the assistance is substantial. It provides that assistance furnished by a related person to a CFC in the form of direction, supervision, services or know-how shall not be considered substantial unless either:

1. The assistance so furnished provides the CFC with skills which are a principle element in producing the income from the performance of such services by the CFC; or
2. The CFC's cost of assistance so furnished equals 50 percent or more of the total CFC's costs of performing the services performed by the CFC. The term cost takes into consideration any adjustments made pursuant to IRC §482, if applicable.

Therefore, if IRC §482 is an appropriate code section to apply to the transactions between the CFC and the related entity, then it has priority. This is significant because the results arising from an IRC §482 issue and arising from a subpart F issue will be different for state purposes. There is a significant difference for federal purposes as well. When an IRC §482 issue is raised between a CFC and its United States parent, the parent does not get the CFC's foreign taxes as a credit. When a subpart F income issue is raised, the treatment to the United States parent is that of a dividend, and the parent gets the benefit of a deemed foreign tax credit pursuant to IRC §960.

For California purposes, generally speaking, a larger adjustment will result if an IRC §482 adjustment is made first to the service income because of the additional apportionment calculation for subpart F income. This is because an adjustment made pursuant to IRC §482 is not dependent on the CFC's earnings and profits. Also, the adjustment is not diluted by adding the CFC's factors to the denominators. Of course the decision of which issue to raise should always be based on the facts and circumstances of the case. Treasury Regulation §1.954-4(b)(2)(ii)(e) provides that assistance furnished by a related person in the form of direction, supervision, services or know-how shall not be taken into account unless the assistance so furnished assists the CFC in the performance of the services performed by such corporation.

For FBCServices, the specific issues to address during an audit are:

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

- 
1. Whether the assistance furnished to or from a CFC in the form of supervision, direction, service or know-how is substantial assistance within Treasury Regulation §1.954-4(b)(2)(ii)(b); and
  2. Whether that same assistance aids the CFC directly in the performance of its income generating activities within the meaning of Treasury Regulation §1.954-4(b)(2)(ii)(e).

This determination is not easy, but can be made. You will find that the audit techniques employed for this issue are very similar to the audit techniques required for an IRC §482 issue and the functional analysis applied in the past for a unity issue. What makes this issue slightly easier than an IRC §482 issue is that you do not have to determine the arm's length value of the furnished assistance. Once you have established which functions are performed by which corporation, a determination can be made. For each CFC service contract, you will need to determine the who, what, where, when and how of the situation.

Assistance in the form of direction, supervision, financing, equipment, materials or supplies, even if not substantial by themselves, may be substantial in combination with other assistance, if it directly assists the CFC in the performance of the service.

Refer to [Exhibit 9.3E](#), which contains a case study on FBCServices. The case demonstrates facts that were uncovered during an audit and their significance.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***f. Foreign Base Company Shipping Income***

#### ***1. In General***

The Tax Reduction Act of 1975<sup>63</sup> added foreign base company shipping income (FBCShipping) to IRC §954. FBCShipping encompasses a broad range of income earned from foreign shipping operations and has been includable as subpart F income for income years beginning on or after January 1, 1976. There was a special income exclusion that permitted the reinvestment of shipping income into qualified shipping operations. However, effective for income years beginning after December 31, 1986, the TRA86 repealed this shipping income exclusion.

FBCShipping is the gross income earned by a CFC that is derived from:

1. Or in connection with, the use (hired or leased) of any vessel or aircraft in foreign commerce;
2. Or in connection with, the performance of services directly related to the use of any such vessel or aircraft;
3. The sale, exchange or other disposition of any such vessel or aircraft;
4. Any activity which is incidental to any such vessel or aircraft activity; and
5. Certain ancillary interest and exchange gains.<sup>64</sup>

Examples of FBCShipping are income derived from dock and warehouse activities. Not only does the operator of a vessel or aircraft receive FBCShipping, so does the owner who charters the vessel or aircraft to the operator.

FBCShipping also includes any income derived from a space or ocean activity, as defined by IRC §863(d)(2),<sup>65</sup> that is not within the jurisdiction of any country, and income from activity in the Antarctic. Income derived by a gambling concessionaire from cruise ship gambling operations is one example of income that would be considered related to ocean activity.<sup>66</sup>

A vessel includes all water craft and other artificial contrivances of whatever description and at whatever stage of construction, whether on the docks or launched, to be used as a means of transportation on water.<sup>67</sup> An aircraft is a machine or device including airplanes, helicopters, gliders and dirigibles, capable of atmospheric flight.<sup>68</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

Vessel or aircraft income from foreign commerce is income derived from, or in connection with, transporting passengers or goods by vessel or aircraft in foreign commerce and income derived from hiring or leasing a vessel or aircraft to another for use in foreign commerce.<sup>69</sup> A vessel or aircraft is used in foreign commerce to the extent it is used (by hire, lease or sublease) in the transportation of goods or passengers:

1. Between a port or airport in the United States or in a possession of the United States and a foreign port or airport;
2. Between a foreign port or airport and another in the same country; or
3. Between a foreign port or airport and one in another foreign country.

For example a trawler, a factory ship and an oil drilling ship are not considered to be used in foreign commerce, while a cruise ship which visits one or more foreign ports is considered to be used in foreign commerce.<sup>70</sup> A vessel or aircraft is used in foreign commerce whether it is chartered to a person for such use; whether the charter is a bareboat or time charter or takes some other form.<sup>71</sup>

Services generating FBCShipping include:

1. Terminal services, e.g., dockage, wharfage, storage, lights, refrigeration;
2. Stevedoring and other cargo handling services;
3. Container related services performed in connection with local drayage or inland haulage of cargo;
4. Services performed by tugs, lighter barges, scows, floating cranes and similar equipment;
5. Maintenance and repairs of any equipment used in these services;
6. Training of pilots and crew;
7. Licensing income from patents, know-how or similar intangibles;
8. Services performed by a booking, operating or managing agent; and
9. Any service performed by the CFC in the actual transportation of passengers and goods.<sup>72</sup>

Income from services related to shipping operations also includes services performed for the passengers, consignor or consignee (e.g., meals, stateroom rentals, demurrage).<sup>73</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

FBCShipping includes certain dividends, interest and gains from certain security dispositions. Specifically, if the CFC receives dividends or interest from, or recognizes gains from the disposition of the stock or obligations of another foreign corporation, then that income is treated as FBCShipping to the extent the dividend, interest and gains are attributable to FBCShipping income of the other corporation, but only if that corporation which issues the dividends or interest falls into one of the following categories:

1. The paying corporation is owned 10 percent or more by the CFC so that a dividend by the paying corporation would entitle the CFC to an indirect foreign tax credit pursuant to IRC §902;
2. The two corporations are related parties; or
3. The paying corporation is a less developed country shipping company.<sup>74</sup>

Note that this section applies to dividends, interest and gains from all foreign corporations meeting the requirements. The foreign corporation is not required to be a CFC.<sup>75</sup> Any passive income that does not meet the above description is included as FPHCI.<sup>76</sup>

Finally, any portion of the distributive income share of a partnership attributable to this type of activity is also considered FBCShipping.<sup>77</sup>

### Example 37:

Le Flags, a CFC, owns a foreign flag tanker which it charts under a long-term bareboat charter to another foreign corporation, Barco, Ltd., for use in foreign commerce. Barco produces oil in a foreign country and ships the oil to other foreign countries and to the United States. The vessel, when not engaged in carrying Barco's oil, is used to carry bulk cargoes for unrelated persons in foreign commerce. The charter hire received by Le Flags constitutes income derived from the use of the vessel in foreign commerce. The income derived by Barco from carrying bulk cargoes for unrelated persons also constitutes income derived from the use of the vessel in foreign commerce.<sup>78</sup>

## 2. *FBCshipping Exceptions*

Income earned in commerce between two points within the CFC's country of incorporation is excluded from FBCShipping. Thus, where a CFC carries on its

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

activities entirely in its country of incorporation and the vessel or aircraft is registered in such country, then that income would be excluded. For example, shipping goods from coast to coast within the same country would be excluded from FBCShipping, assuming the vessel or aircraft is registered in the same country.<sup>79</sup>

In addition, FBCShipping does not include income derived from international communications and natural deposits activity that is performed within the jurisdiction of the CFC's country of incorporation.<sup>80</sup>



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***g. Foreign Base Company Oil Related Income***

#### ***1. In General***

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)<sup>81</sup> added foreign base company oil related income (FBCO) to FBCI. FBCO includes "downstream" oil related income. It specifically excludes extraction income. FBCO consists of foreign oil related income which is income generated from sources outside the United States and its possessions by the following activities:

1. Processing minerals extracted from oil or gas wells into their primary products;
2. Transporting such minerals or primary products;
3. Selling or distributing such minerals or primary products;
4. Disposing any assets used in a trade or business described in the above activities; and
5. Performing any other related service.<sup>82</sup>

Accordingly, FBCO includes income derived from processing, transporting, storage, distributing or re-selling of petroleum or their primary products and any gain on the disposition of assets used in these activities. However, FBCO does not include extraction income. FBCO also includes any dividend and interest income from foreign corporations if the income is attributable to the oil related operations.<sup>83</sup> Finally, any portion of the distributive income share of a partnership attributable to this type of activity is also considered FBCO.<sup>84</sup>

Income qualifying as FBCShipping that is related to oil and gas activities is not included as FBCO. This income remains subject to the subpart F rules within the definition of FBCShipping. However, passive types of income and other income types that also meet the definition of FPHCI, FBCSales or FBCServices remain in FBCO.<sup>85</sup>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### 2. *FBCO Exceptions*

FBCO only applies to large oil producers. IRC §954(g)(2) defines a large oil producer as one where the CFC and its related group produces a daily average of 1,000 barrels of oil or its equivalent in natural gas for the current or prior year.<sup>86</sup> Average daily production only includes crude oil and natural gas from wells outside the United States and its possessions.

FBCO does not include income derived within a foreign country where the:

1. Oil or gas was extracted from a well within that country;<sup>87</sup>
2. Oil, gas or a primary product of oil and gas is sold for use or consumption within that foreign country; or
3. Oil, gas or a primary product of oil and gas is loaded in that country on a vessel or aircraft as fuel for that vessel or aircraft.<sup>88</sup>

The effect of this exception is to focus on the source of the income, not, as in other foreign base company rules, the country of the CFC's incorporation.

Example 38:

Rhoco Oil Sales, S.A., is wholly owned by Rhoco Petroleum, B.V., which is a CFC owned by Rhoco Oil Company. Rhoco Oil Sales buys the production of Rhoco Petroleum in Venezuela and then re-sells the petroleum to an unrelated refining company. Title to the petroleum passes to the refining company in Venezuela. Is the income FBCShipping?

Answer: No. The income earned by Rhoco Oil Sales is not FBCShipping because the income was earned in the country where the oil was extracted.

Example 39:

Saudi, Inc., operates a refinery in Saudi Arabia and also leases an oil field there. In 1994, Saudi earned \$825,000 from oil extraction and \$225,000 from refining. Seventy percent of the income from oil extraction was derived from Saudi Arabia. Forty percent of the fuel refined was derived from Saudi Arabia. How much FBCO does Saudi have?

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

Answer: Saudi has FBCO of \$135,000. The income from oil extraction is not included in the definition of FBCO. Of the refining income, forty percent (\$90,000) is excluded because forty percent of the income was derived from oil wells within Saudi Arabia. Saudi has FBCO of \$135,000 (\$225,000 X 60%).

And finally, as mentioned in section b of this chapter, FBCI Exceptions and Special Rules, the high foreign tax rule cannot be applied to exclude oil related income as FBCO.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***h. Adjusted Net FBCI***

The discussion to this point has addressed *gross FBCI* and has not discussed the related expenses. However, the actual income amounts that would be reported for federal purposes must consider applicable expenses. Gross FBCI is the total income earned by a CFC that has satisfied the definitions within the FBCI rules. It is comprised of either gross FPHCI, gross FBCSales, gross FBCServices, gross FBCShipping or gross FBCO.<sup>89</sup>

Once the gross FBCI is determined, the next step is to determine the *adjusted gross FBCI*. The adjusted gross FBCI is the gross FBCI adjusted by the effects of applying both the de minimis and full inclusion rules to each FBCI category.<sup>90</sup> From the adjusted gross FBCI, the *net FBCI* would then be derived. The net FBCI is the adjusted gross FBCI of the CFC reduced by the deductions properly allocated and apportioned to the respective categories of the FBCI.<sup>91</sup> From the net FBCI, the *adjusted net FBCI* is determined, which is the net FBCI reduced by the effects of applying the high foreign tax rule.<sup>92</sup>

For federal purposes, once the adjusted net FBCI has been determined, then the United States shareholder would report as a deemed dividend its respective ownership portion of the CFC's adjusted net FBCI on its federal Form 1120.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

### *i. Expense Allocation Rules*

#### **1. In General**

Once the adjusted gross FBCI has been determined by "income item", then the adjusted gross FBCI must be reduced by deductions (including taxes) properly allocable to the income.<sup>93</sup>

In general, expenses are allocated pursuant to IRC §904(d),<sup>94</sup> Treasury Regulation §1.904-5(c)(2), and Treasury Regulation §1.861-8T through Treasury Regulation §1.861-10T. In terms of what qualifies as valid deductions, the net income is determined as if the CFC were a domestic corporation and the federal tax provisions were applied to the income and expense items.

The first step is to deduct the expenses (other than related-party interest expense) that are directly related to an item of income. The next step is to reduce the FPHCI by related-party interest expense. The last step is to deduct expenses not directly related to an item of income. Expenses that do not apply to any FBCI category are disregarded.<sup>95</sup>

Related party interest expense is defined as any interest paid or accrued by the CFC to a United States shareholder or to a related CFC.<sup>96</sup> Thus, any of this interest expense is first applied to FPHCI. However, remember this interest expense cannot reduce the FPHCI below zero. Thus, to the extent that related party interest exceeds FPHCI, it is apportioned to the other categories of FBCI. There are two options, the modified gross income method or the asset method pursuant to Treasury Regulation §1.861-9T, the corporation can apply to apportion the excess related party interest expense to the other FBCI categories:

#### The Modified Gross Income Method:

Relating party interest	X	<u>Separate Category Gross</u>
		<u>FBCI</u>
Exceeding FPHCI		Total Gross FBCI

#### The Asset Method:

Relating party interest	X	<u>Separate Category Asset</u>
-------------------------	---	--------------------------------

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

	<u>Value</u>
Exceed FPHCI	Total Asset Value

The other FBCI expenses (including unrelated party interest expense), not definitely related (allocated) to a specific FBCI category, are apportioned using the same two methods. Thus, the corporation has the same option of using either the modified gross income method or the asset method. However, in the above formulas, the related party interest expense exceeding the FPHCI amount would be substituted by the expense amount.<sup>97</sup>

A CFC cannot use the gross income method if the United States shareholders are using the fair market value asset method to allocate their expenses for foreign tax credit purposes. Also, all related CFCs are required to consistently use the same method, either the income or asset method to allocate interest expense.<sup>98</sup> Further, if there are tiers of CFCs, the interest expense allocation becomes more complicated using the gross income method because there is a look-through rule. Treasury Regulation §1.861-9T(i) explains how to compute the allocation using the gross income method. Refer these regulations for more detail related to this allocation.

With the exception of interest expense, directly related expenses are allocated and apportioned to gross income in the same manner as that used within the effectively connected income provisions. These allocation and apportionment rules are discussed in detail in Chapter 8, Water's-Edge Manual. Refer to that chapter for more information.

### **2. Allocation Rules - Examples**

Example 40:

Xtra S.A., an Australian CFC, has gross income from two sources, \$100,000 from the manufacture and selling of tires and \$100,000 it derives from tires it purchases from its United States parent and sold in New Zealand. Xtra has \$175,000 of expenses, including taxes, of which \$90,000 is definitely related and allocable to the manufacturing operation. The remaining expenses, \$85,000, are definitely related and allocable to the tires sales purchased from its parent. What is Xtra's FBCI?

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

Answer: The income from manufacturing is not considered FBCSales. However, Xtra does have FBCSales from the tire sales purchased from the parent. Thus, Xtra's net income is \$25,000 while its FBCI is \$15,000 determined as follows:

<u>XTRA</u>	<u>MANUFACTURING</u>	<u>SALES</u>	<u>TOTAL</u>
Gross Income	\$100,000	\$100,000	\$200,000
Expenses Allocated to Each Source of Income	<u>90,000</u>	<u>85,000</u>	<u>175,000</u>
Net Income	<u>\$10,000</u>	<u>\$15,000</u>	<u>\$25,000</u>

Example 41:

O'Golly, Ltd., an Irish CFC, performed services in Ireland, Germany, France, Sweden and Italy. It has the following service income and related expenses:

<u>O'GOLLY</u>	<u>Ireland</u>	<u>Germany</u>	<u>France</u>	<u>Sweden</u>	<u>Italy</u>	<u>Total</u>
Receipts from Services performed for related parties	\$500	\$282	\$205	\$355	\$200	\$1,545
Receipts from services performed for unrelated parties	<u>45</u>	<u>100</u>	<u>80</u>	<u>105</u>	<u>50</u>	<u>380</u>
Gross Income	\$545	\$385	\$285	\$460	\$250	\$1,925
Total expense	<u>450</u>	<u>315</u>	<u>150</u>	<u>300</u>	<u>10</u>	<u>1,225</u>
Net Income	<u>\$95</u>	<u>\$70</u>	<u>\$135</u>	<u>\$160</u>	<u>\$240</u>	<u>\$700</u>

What is O'Golly's FBCServices?

a

Answer: The services performed in Ireland do not meet the definition of FBCServices. The services performed for unrelated parties also do not meet the definition of FBCServices. Accordingly, the FBCServices are:

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

# CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

<u>O'GOLLY</u>	<u>German</u> <u>y</u>	<u>France</u>	<u>Sweden</u>	<u>Italy</u>	<u>Total</u>
FBCServices	\$285	\$205	\$355	\$200	\$1,045
Apportioned Expenses	<u>233</u>	<u>108</u>	<u>232</u>	<u>8</u>	<u>581</u>
Net FBCServices	<u>\$52</u>	<u>\$97</u>	<u>\$123</u>	<u>\$192</u>	<u>\$464</u>

Note that the expense apportionment was determined based on gross income of each country. Thus, the German expenses were \$233 ( $\$315 \times \$285/\$385$ ); the French expenses were \$108 ( $\$150 \times \$205/\$285$ ); the Swedish expenses were \$232 ( $\$300 \times \$355/\$460$ ); and the Italian expenses were \$8 ( $\$10 \times \$200/\$250$ ).

Example 42:

Flute, Ltd., a Panamanian CFC, manufactures reed flutes in Panama and sells them to related companies worldwide. Flute's income breakdown is as follows:

	<u>MFG</u>	<u>Dividends</u>	<u>Interest</u>	<u>Total</u>
Sales	\$2,000,000			\$2,000,000
Cost of Goods	<u>(1,100,000)</u>			<u>(1,100,000)</u>
Gross Profit	<u>\$900,000</u>			900,000
Dividends		<u>\$52,000</u>		52,000
Interest			<u>\$50,000</u>	50,000
Gross Income	\$900,000	\$52,000	\$50,000	\$1,002,000
Expenses	<u>(496,000)</u>	<u>(1,000)</u>	<u>(5,000)</u>	<u>(502,000)</u>
Net Income	\$404,000	\$51,000	\$45,000	\$500,000
Tax Paid	<u>(80,800)</u>	<u>(10,200)</u>	<u>(9,000)</u>	<u>(100,000)</u>
Net Income after tax	<u>\$323,200</u>	<u>\$40,800</u>	<u>\$36,000</u>	<u>\$400,000</u>

Note that in addition to the above, Flute also incurred a \$50,000 consulting fee that is not specifically allocable to any one type of income. The services were related to management concerns affecting all types of income. What is Flute's net subpart F income?

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

**Answer:** The net subpart F income is \$74,375. The manufacturing income does not meet the definition of FBCSales since Flute is the manufacturer. The dividend and interest income does meet the definition of FPHCI. Accordingly, FPHCI is:

<b><u>FLUTE</u></b>	<b><u>Total</u></b>
FPHCI	\$102,000
Allocated Dividend Expense	(11,200)
Allocated Interest Expense	(14,000)
Apportioned Dividend Expense	(1,235)
Apportioned Interest Expense	(1,190)
Net FPHCI	<u>\$74,375</u>

Note that the allocated expenses are comprised of the direct expenses, including taxes paid. The expense apportionment was determined based on the gross income of each income type. Thus, the dividend expense is \$2,595 ( $\$50,000 \times \$52,000 / \$1,002,000$ ); and the interest expense is \$2,495 ( $\$50,000 \times \$50,000 / \$1,002,000$ ). Also note that neither the de minimis rule, the full inclusion rule nor the high foreign tax rule apply here.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### *j. California Audit Considerations*

As always, you will have to adjust your audit approach to the facts and circumstances of your audit. In some cases, a taxpayer may have hundreds of CFCs. In that situation, an efficient way to approach the case may be to identify the CFCs that are most likely to have a material subpart F issue, and focus your examination on only those entities. For example, make a list of all CFCs that can be identified from the California return, the federal Form 1120, the federal Form 5471 and the taxpayer's Annual Report. You may decide to eliminate a CFC from your list for reasons such as:

1. The CFC is owned less than 50 percent by the water's-edge group. Thus, unity of ownership does not exist and the CFC may not be included in the water's-edge group;
2. You have obtained a copy the IRS International Examiner's IDRs and have identified the CFCs that will be audited by the IRS;
3. The CFC is inactive or has minimal activity;
4. The CFC is manufacturing (refer to comment #3 below); or
5. The CFC operates in a high foreign tax jurisdiction.
6. The tax effect for partial inclusion is immaterial.

For any remaining CFC you wish to examine further, you should request a profit and loss statement for that CFC. You will need to know the CFC's sources of income. Once you have the CFC income information, you can use this chapter as a guide to determine whether or not subpart F income exists.

The following are miscellaneous comments to keep in mind:

1. Unless the de minimis rule or the high foreign tax rule applies, in general, interest income should meet the definition of FPHCI.
2. If a CFC is listed as a holding company, then most of its income should meet the definition of FPHCI. This was discussed in Example #19 in Part of Section 9.3(c), Water's-Edge Manual. Also discussed in Example #19 is the effect of having a lower-tier CFC and a higher-tier CFC. You should ensure the taxpayer has not eliminated income from subpart F income because of rules (IRC §959(b)) to which we have not conformed.
3. It is common for a CFC's operations to be classified as "manufacturing" on the federal Form 5471 because this is a significant exception for

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

FBCSales. If the federal Form 5471 states the CFC is manufacturing, the auditor should review the cost of goods sold schedule to determine what percentage labor expense is in relation to total cost of goods sold. If the percentage is minimal or low, the classification as a manufacturer may be incorrect.

4. Remember to look for a CFC operating a branch to ensure the branch rules are properly applied as discussed in Part 4 of Section 9.3(c), Water's-Edge Manual.
5. For a CFC with a high percentage of its income qualifying as subpart F income, apply the full inclusion rule to determine if the CFC meets the test and should have 100 percent of its income included as subpart F income. This rule was discussed in Part 3 of Section 9.3(b), Water's-Edge Manual.
6. For a CFC with a large inclusion ratio but with minimal net income and substantial property, payroll or sales in a foreign country, apply the de minimis rule. (The de minimis rule is discussed in Part 1 of Section 9.3-3, Water's-Edge Manual.) If the de minimis rule applies, the CFCs minimal income and the foreign property, payroll, and sales may be excluded from the combined report. The reduction to the apportionment factor denominators will increase the apportionment formula.
7. If the taxpayer states that income is excluded from subpart F income because of the high foreign tax rule, you can request that the taxpayer substantiate the amount of foreign tax paid by providing the foreign tax return and proof of payment.
8. With the exception of interest expense, the allocation and apportionment rules used for effectively connected income of a United States trade or business is also applied for purposes of determining net subpart F income. For the CFCs that the taxpayer included in the water's-edge combined report, ensure that the proper interest expense allocation and apportionment has been calculated as discussed in Part 1 of Section 9.3(i), Water's-Edge Manual.
9. Refer to the case study at [Exhibit 9.3E](#). Note the fact that alternative positions are addressed by the IRS auditor. A field auditor should map out alternative positions and their strengths and weaknesses. Thus, should the case be assigned to the Legal Branch or the Settlement Bureau, the possibilities are laid out for the attorney or the Settlement Officer.
10. The tax effect of including a large holding company may be deceiving. If the majority of the CFC's income consists of dividends, there may be little if any tax effect since the dividends may be eliminated or deducted under Revenue & Taxation Code sections 24411 or 25106.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

- 
11. Do **not** strictly rely on the subpart f income reported on the 5471 for inclusion ratio purposes. There may be differences between what is reported for federal purposes and what should be included in the numerator of the inclusion ratio, and the 5471 you are looking at are not numbers that are generally audited. See Section 9.2(b), Water's-Edge Manual for a more detailed discussion.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***k. Summary***

This section discussed and described the specific categories of FBCI: FPHCI, FBCSales, FBCServices, FBCShipping and FBCO. FBCI differs from the other categories of subpart F income because additional tests that must be applied to determine whether or not the FBCI will be considered subpart F income. These additional tests, the de minimis rule, the high foreign tax rule and the full inclusion rule, apply to both FBCI and insurance premium income.

In general, FPHCI is passive income earned by a CFC. Interest income will almost always be classified as FPHCI. An overlap exists with the PFIC provisions, which defines passive income applying the definition of FPHCI within the subpart F provisions. When passive income can be taxed subject to both the subpart F and PFIC provisions, then the subpart F rules will take precedence.

FBCSales is derived from the purchase and sale of personal property by the CFC under certain conditions. Such sales will be excluded if the CFC is considered to have manufactured the property. For this determination there are two tests, the substantial transformation test and the substantial operations test.

FBCServices is derived from services rendered by the CFC for or on behalf of a related person and performed outside the CFC's country of incorporation. Included in FBCServices are services where the CFC received "substantial assistance" from a related person. This is a common and significant issue.

FBCShipping and FBCO are types of FBCI that are not very common. FBCShipping applies to aircraft or vessels carrying foreign commerce while FBCO applies only to large oil producers. Exhibit 9.3A contains an IRC subpart F Summary; Exhibit 9.3B contains a diagram summarizing FPHCI; Exhibit 9.3C contains a diagram summarizing FBCSales; Exhibit 9.3D contains a diagram summarizing FBCServices; and Exhibit 9.3E contains a case study discussing a FBCServices issue.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **Footnotes**

1. Internal Revenue Code (IRC) §954(b)(4).
2. IRC §954(b)(3).
3. California Code of Regulations §25110(d)(2)(F)(iii).
4. IRC §954(b)(3)(a)(C).
5. Treasury Regulation (TR) §4.954-1(b)(1)(ii)(2).
6. Treasury Regulation §4.954-1(d)(1).
7. Treasury Regulation §4.954-1(d)(4)(ii)(B).
8. Treasury Regulation §4.954-1(d)(4).
9. Treasury Regulation §4.954-1(d)(2).
10. IRC §954(b)(3)(a)(C).
11. Treasury Regulation §4.954-1(b)(4).
12. Public Law (PL) 99-514, Tax Reform Act of 1986, dated October 22, 1986, 1986-3 Cumulative Bulletin (CB), page 1.
13. Treasury Regulation §4.954-2(e)(1)(i).
14. Treasury Regulation §4.954-2(f)(2)(i).
15. Treasury Regulation §4.954-2(f)(2)(ii).
16. Treasury Regulation §4.954-2(f)(1).
17. Treasury Regulation §4.954-2(g).
18. Treasury Regulation §4.954-2(a)(4)(i).
19. Treasury Regulation §4.954-2(h)(3)(i).
20. Treasury Regulation §4.954-2(h)(3)(ii)(A).
21. IRC §864(d).
22. Treasury Regulation §4.954-2(b)(6).
23. IRC §954(c)(2)(B).
24. IRC §954(c)(3)(A)(i).
25. Treasury Regulation §4.954-2(b)(3)(iv).
26. IRC §954(c)(3)(B).
27. IRC §954(c)(3)(C).
28. IRC §954(c)(2).
29. IRC §954(c)(3)(A)(ii).
30. Ibid., note #26.
31. IRC §954(c)(1)(B).
32. Ibid., note #31.
33. Treasury Regulation §4.954-2(f)(3).
34. Treasury Regulation §4.954-2(g)(2).
35. Treasury Regulation §4.954-2(g)(3).
36. Treasury Regulation §4.954-2(g)(4).

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

- 
37. Treasury Regulation §1.959-2(b), Example (b).
  38. IRC §954(d)(1).
  39. IRC §954(d)(3).
  40. IRC §954(d)(1)(A).
  41. IRC §954(d)(1)(B).
  42. IRC §954(d)(4)
  43. Treasury Regulation §1.954-3(a)(5)
  44. Treasury Regulation §1.954-3(a)(2)
  45. Treasury Regulation §1.954-3(a)(3)
  46. Treasury Regulation §1.954-3(a)(4)
  47. Ibid., note #46.
  48. Treasury Regulation §1.954-3(a)(4)(ii), Example 1, 2 and 3.
  49. Bausch & Lomb, Inc. v. Comm., 71 TCM 2031 1996, TC MEMO 1996-57
  50. Treasury Regulation §1.954-3(a)(4)(iii), Example 1.
  51. Treasury Regulation §1.954-3(a)(4)(iii), Example 3.
  52. IRC §954(d)(2)
  53. Treasury Regulation §1.954-3(b)(1)(i)(b).
  54. Treasury Regulation §1.954-3(b)(1)(ii)(b).
  55. Treasury Regulation §1.954-3(b)(1)(i)(c). Treasury Regulation §1.954-3(b)(1)(ii)(c).
  56. Treasury Regulation §1.954-3(b)(3).
  57. Treasury Regulation §1.954-3(a)(5).
  58. IRC §954(e).
  59. Treasury Regulation §1.954-4(b)(1)(i)-(iv).
  60. IRC §954(e)(2). Treasury Regulation §1.954-4(d).
  61. Treasury Regulation §1.954-4(b)(2)(i).
  62. Treasury Regulation §1.954-4(b)(2).
  63. PL 94-12, Tax Reduction Act of 1975, dated March 29, 1975, 1975-1 CB, page 545.
  64. Treasury Regulation §1.954-6(b).
  65. IRC §954(f).
  66. Income Taxation of Foreign Related Transactions, Volume, Matthew Bender, February 1995, page 3-140.
  67. Treasury Regulation §1.954-6(b)(3)(ii).
  68. The American Heritage Dictionary, second edition, Houghton Mifflin Company.
  69. Treasury Regulation §1.954-6(c)(1).
  70. IRC §954-6(b)(3)(i).
  71. Treasury Regulation §1.954-6(b)(4).

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

- 
72. Treasury Regulation §1.954-6(d)(2).
  73. Treasury Regulation §1.954-6(d)(3).
  74. Treasury Regulation §1.954-6(f)(1)(ii).
  75. Treasury Regulation §1.954-6(h)(1).
  76. IRC §954(f)
  77. IRC §954(f)(2).
  78. Treasury Regulation §1.954-6(c)(2), Example (2)
  79. IRC §954(b)(7).
  80. IRC §863(d)(2)(B).
  81. PL 97-248, Tax Equity and Fiscal Responsibility Act of 1982, dated September 03, 1982, 1982-2 CB, page 462.
  82. IRC §954(g)(1). IRC §907(c)(2) and (3).
  83. Ibid., note #82.
  84. Ibid., note #82.
  85. IRC §954(b)(8).
  86. IRC §954(g)(2)(D). IRC §613A.
  87. IRC §954(g)(1)(A).
  88. IRC §954(g)(1)(B).
  89. Treasury Regulation §.954-1(a)(2).
  90. Treasury Regulation §4.954-1(a)(3).
  91. Treasury Regulation §4.954-1(a)(4).
  92. Treasury Regulation §4.954-1(a)(5).
  93. IRC §954(b)(5).
  94. Treasury Regulation §4.954-1(c).
  95. Treasury Regulation §1.861-8.
  96. Treasury Regulation §1.904-5(c)(2).
  97. Treasury Regulation §1.904-5(c)(2)(ii)(E).
  98. Treasury Regulation §1.861-9T(f)(3).



## **CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **Section 9.4 Treatment Of Partnership Income And Hybrid Branches Under Subpart F Rules**

#### ***Contents:***

- a. Partnership Income
- b. Hybrid Entities and the Check the Box Rules
- c. Summary

#### ***References:***

Internal Revenue Code §952, §954  
Temporary and Proposed Regulations under IRC §952, §954  
Rev. Rul. 96-39  
Rev. Rul. 98-35

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **a. Partnership Income**

To the extent that income would be considered subpart F income if earned directly by a CFC, the CFC should not be able to avoid the subpart F rules by instead receiving the income indirectly through a partnership. For example, if a CFC purchased inventory from its US shareholder and resold the goods to unrelated persons, the income would be considered subpart F income (FBCSales). The issue involves a situation where the CFC conducts the inventory transactions through a foreign partnership (the partnership purchases the inventory from the CFC's US shareholders and resells it to the unrelated parties). Instead of receiving the income directly, the CFC partner receives it in the form of its distributive share of partnership income.

The issue of whether a CFC partner's distributive share of income earned by a foreign partnership qualifies as FBC Sales was addressed in Brown Group, Inc. v. Commissioner.<sup>1</sup> The tax court based its decision on what is called the "aggregate theory." The decision concluded that a partnership should be treated as an aggregate of its partners, which means you can look to the CFC partner to determine whether the income qualifies as subpart F income. Because the U.S. shareholders were a related party of the CFC, the partner's income was determined to be FBCSales. The Brown Group decision was overturned by the 8<sup>th</sup> Circuit Court of Appeals. The appellate court concluded that the "entity theory" should be applied when determining whether the income constituted as subpart F income. The entity theory treats the partnership as separate and distinct from its partners. Because the U.S. shareholders were not related parties to the partnership under the subpart F rules, the partnership's sales were not FBCSales.

In response to the appellate court's decision, the IRS issued Notice 96-39.<sup>2</sup> The purpose of this notice is to confirm the IRS's position that it disagrees with the appellate court's decision and that it will continue to treat partnerships as an aggregate of its partners based on other existing authorities. In 1998, the IRS issued proposed regulations under subpart F to clarify its position.

In general, the proposed regulations provide that a CFC's share of gross income of a partnership will be subpart F income to the extent that the income would have been subpart F income if received by the CFC partner directly. Also, the determination of whether an entity is a related person or whether the activity

## **CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

takes place within the CFC's country of incorporation is made with respect to the CFC partner, not the partnership. (See Proposed Regulations §1.952-1(b) and §1.954-1(g).) The proposed regulations also clarify how certain subpart F exceptions and special rules should be applied when partnerships are involved – see Proposed Regulations under §1.954-2, §1.954-3 and §1.954-4.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### ***b. Hybrid Entities Under The "Check The Box" Rules***

Effective for income years beginning on or after 1/1/97, California conformed to the federal "check-the-box rules". Under prior law, a foreign entity was classified as a corporation if it possessed more corporate characteristics than non-corporate characteristics. Now, the check-the-box rules permit a taxpayer to elect the classification of many foreign entities for tax purposes. An eligible foreign entity may be classified as a branch, partnership or corporation upon election. Because a check-the-box election can cause an entity to be classified differently for U.S. tax purposes than for foreign tax purposes, such entities are termed "hybrid entities". See Section 2.9, Water's-Edge Manual for detailed information on the check-the-box rules.

The ability to classify an entity differently for U.S. tax purposes and for foreign tax purposes provides taxpayers with an opportunity to reduce foreign taxes while avoiding the corresponding creation of subpart F income. For example, if a foreign entity in one jurisdiction pays dividends, interest, rents, royalties, etc. to another foreign entity in a lower tax jurisdiction, the aggregate foreign tax liability will be reduced (because a higher tax rate is applied to the payor's deduction than to the payee's corresponding income). Under subpart F, such payments between distinct CFCs would normally constitute foreign personal holding company income. However, if one of the CFCs is wholly-owned by the other CFC, the U.S. shareholder can disregard the corporate status of the wholly-owned CFC and treat it as a branch of its owner. Because payments between branches of a single entity are not recognized for U.S. tax purposes, the payments would no longer be subpart F income. Such opportunities exist not only for payments between a CFC and its own hybrid branch, but also for payments between hybrid branches of related CFCs, hybrid branches of partnerships, etc.

On January 16, 1998, the IRS issued Notice 98-11 to announce its intention to issue regulations to prevent the use of certain arrangements involving CFCs and hybrid branches. Temporary and proposed regulations to accomplish this were issued on March 23, 1998. The proposed rules triggered substantial public debate, and the on July 6, 1998, the IRS issued Notice 98-35 to withdraw both Notice 98-11 and the temporary and proposed regulations. However, Notice 98-35 also announced that new regulations would be proposed. The new

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

regulations would retain most of the features of the March 23, 1998 temporary and proposed regulations, but would have new dates of applicability to give Congress and the Treasury an opportunity to consider in greater depth the issues pertaining to hybrid transactions.

The new temporary and proposed regulations were released on July 9, 1999. Under these proposed regulations, payments involving hybrid branches will give rise to subpart F income when certain conditions are met. The proposed regulations make it clear that the hybrid branches will be treated as separate entities only for purposes of recharacterizing non-subpart f income as subpart f income. The hybrid branch status will continue to be respected for all other purposes. However, even if finalized in their present form, the new proposed regulations will not be effective for payments made before January 16, 1998 or for hybrid arrangements entered into before that date (unless the arrangement is substantially modified after that date). Additional transitional rules also apply which may further delay the effective date for certain payments. Finally, additional proposed regulations were also released in November, 1999 to provide special treatment for certain dispositions of interests in disregarded entities in extraordinary transactions (Proposed Regulation §301.7701-3(h)).

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **c. Summary**

A CFC's share of gross income of a partnership will be subpart F income to the extent that the income would have been subpart F income if received by the CFC partner directly. Also, the determination of whether an entity is a related person or whether the activity takes place within the CFC's country of incorporation is made with respect to the CFC partner, not the partnership.

Currently, the check-the-box rules provide opportunities for CFCs to prevent transactions involving hybrid entities from being characterized as subpart F income. Regulations are pending which will limit such opportunities.

## **CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Water's Edge Manual

Rev.: September 2001

---

### **Footnotes**

1. Brown Group, Inc. v. Comm. (1996, CA8) 77 AFTR 2d 96-510
2. Notice 96-39, 1996-32 IRB, 7/16/96-IRC Sec. 951, 954

**The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated**